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No. 537

Supreme Court of the United States

October Term, 1963

NORDEN-KELLY CORPORATION (formerly Kelly Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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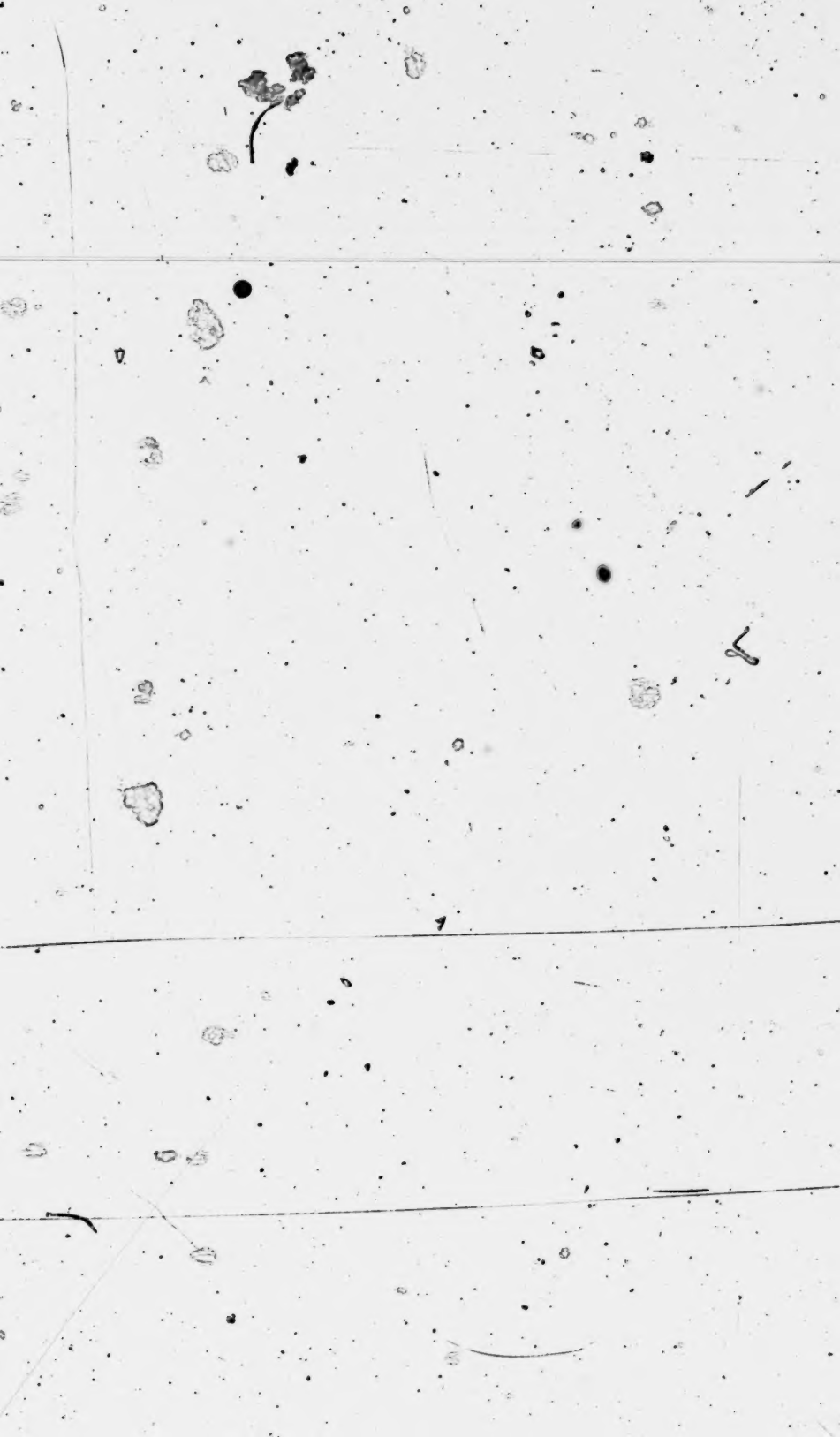

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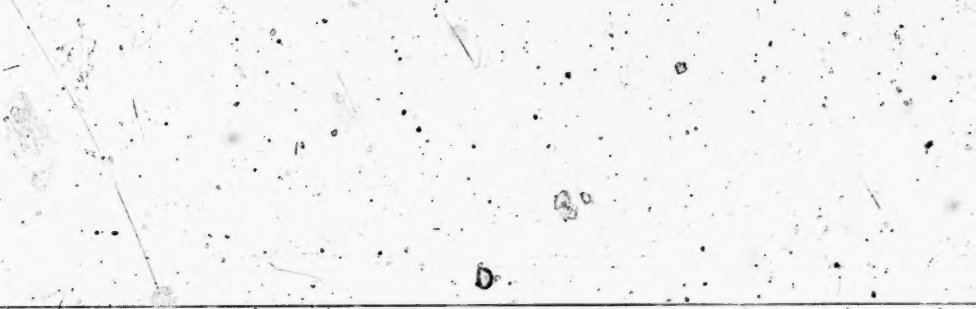

Supreme Court of the United States

OCTOBER TERM, 1963

No.

NORDEN-KETAY CORPORATION (formerly Ketay Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above cause on June 28, 1963 [App. p. 9a],[1] affirming an order and decision of the Tax Court of the United States entered on October 24, 1962 [App. p. 23a].

I. OPINIONS BELOW

The Tax Court of the United States filed its Memorandum Findings of Fact and Opinion [App. pp. 11a-23a], designated T. C. Memo. 1962-248, Docket No. 82272, on October 23, 1962, and entered its Order and

[1] The following abbreviations are used herein: App.—Appendix hereto; Tr.—Transcript of the hearing before the Tax Court; Stip.—Stipulation; Ex.—Exhibit; R.—Record.

Decision [App. p. 23a] on October 25, 1962. The Findings and Opinion of the Tax Court are not officially reported, but are unofficially reported at 21 CCH TCM 1316 and at 31 P-H TCM ¶ 62,248.

The United States Court of Appeals for the Second Circuit handed down its decision [App. pp. 1a-8a] and entered its judgment [App. p. 9a] on June 28, 1963. The opinion of the Court of Appeals is reported at 319 F.2d 902.

II. JURISDICTION

The Court of Appeals for the Second Circuit entered its decision on June 28, 1963. Petitioner's petitions for rehearing and rehearing in banc timely filed on July 12, 1963, were denied on July 30, 1963. [App. p. 10a]. The Petitioner has complied with Rules 21 and 22, Revised Rules of the Supreme Court of the United States. The last day for filing this petition is October 28, 1963. This Court's jurisdiction to review the decision of the Court of Appeals on writ of certiorari is conferred by 62 Stat. 928, June 25, 1948, 28 U.S.C. § 1254 (1958 ed.); 68A Stat. 890, Aug. 16, 1954, 26 U.S.C. § 7482 (1958 ed.); 62 Stat. 961, June 25, 1948, 63 Stat. 104, May 24, 1949, 28 U.S.C. § 2101 (1958 ed.). See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *Reo Motors, Inc. v. Commissioner*, 338 U.S. 442 (1950).

III. QUESTION PRESENTED

Where new stockholders, who, without any tax-avoidance purpose and solely for good business reasons, have purchased substantially all the stock of a coal mining corporation and have thereafter caused the corporation to sell its coal mining assets, and where it is first discovered about a year later that the sale of assets re-

sulted in a net operating loss which under all statutory provisions is allowable as a carryforward deduction, is there any extra-statutory rule precluding that same corporation from carrying forward and deducting that loss against income produced by electronics manufacturing assets thereafter purchased solely with the loss corporation's own cash and credit?

IV. STATUTES INVOLVED

(A) Internal Revenue Code of 1954, § 172, 26 U.S.C. § 172 (1958 ed.), 68A Stat. 63; Aug. 16, 1954, P.L. 85-866, 72 Stat. 1611, 1656, 1678, Sept. 2, 1958.

Petitioner's net operating loss deduction as claimed for 1954 is allowed under Subsection (a) of said Section 172 of the Internal Revenue Code of 1954, which provides in relevant part as follows:

> "There shall be allowed as a deduction for the taxable year an amount equal to . . . the net operating loss carryovers to such year. . . . For purposes of this subtitle, the term 'net operating loss deduction' means the deduction allowed by this subsection."

Section 172 as in effect for 1954 is set forth in full in the Appendix hereto, pp. 25a-32a.

(B) (1) Internal Revenue Code of 1954, § 269, 26 U.S.C. § 269 (1958 ed.), 68A Stat. 80, Aug. 16, 1954; (2) Internal Revenue Code of 1939, § 129, 26 U.S.C. § 129 (1952 ed.), 58 Stat. 47, February 25, 1944; (3) Internal Revenue Code of 1954, § 382(a), 26 U.S.C. § 382(a) (1958 ed.), 68A Stat. 129, Aug. 16, 1954. These statutory provisions are inapplicable, as discussed in text, but are relevant for that reason alone, and the pertinent portions thereof are set out in full in the Appendix hereto respectively at pp. 34a-35a, pp. 32a-33a, and pp. 36a-37a.

(C) The following Rulings of the Commissioner of Internal Revenue to which frequent reference is made, namely, *Rev. Rul. 58-603*, 1958-2 Cum. Bull. 147; *Rev. Rul. 59-395*, 1959-2 Cum. Bull. 475; and *Rev. Rul. 63-40*, 1963-12 Int. Rev. Bull. 8, are also set forth in full in the Appedix hereto respectively at p. 38a, pp. 38a-45a, and pp. 45a-48a.

V. STATEMENT OF THE CASE

The Tax Court disallowed Petitioner's net operating loss carryforward deduction from 1951 to 1954 and for that reason determined a deficiency in Petitioner's Federal income taxes for the year 1954 in the amount of $630,033.33 [App. p. 23a]. The Tax Court had jurisdiction under Internal Revenue Code of 1954, § 6213, 26 U.S.C. § 6213 (1958 ed.), 68A Stat. 771, Aug. 16, 1954, and Internal Revenue Code of 1954, § 6214, 26 U.S.C. § 6214 (1958 ed.), 68A Stat. 773, Aug. 16, 1954.

On Petitioner's appeal, the Court of Appeals for the Second Circuit affirmed the disallowance of the carryforward deduction and affirmed the determination of a deficiency. [App. p. 9a]. The Court of Appeals had jurisdiction under Internal Revenue Code of 1954, § 7482, 26 U.S.C. § 7482 (1958 ed.), 68A Stat. 890, Aug. 16, 1954.

There is no dispute that Petitioner sustained a net operating loss in the year 1951, as to the amount of such loss, or as to the amount of loss available for carryforward to the year 1954. There is no dispute as to the relevant facts.[2]

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[2] Except where the detailed Statement contains references to parts of the record herein, the facts are as found in the Memorandum of Facts and Opinion of the Tax Court which were adopted in toto by Respondent in his brief to the Court of Appeals.

(A) In very brief summary the facts are these:

In 1951, Lehman Brothers, pursuant to options substantially all of which were obtained in 1950, purchased about 95 per cent of the outstanding stock of Petitioner which for many years had engaged in coal mining. Lehman Brothers had no tax purpose of any sort for such purchase of stock and had no knowledge or awareness that any tax benefit of any sort might arise for possible future use. After the purchase of stock, Lehman Brothers caused Petitioner to sell substantially all its assets to an unrelated purchaser and to distribute a large part of the proceeds of sale. Approximately one year after that sale of assets and before Petitioner had received all of the sales price, it was for the first time discovered that Petitioner's sale of assets had resulted in a net operating loss. Thereupon Lehman Brothers decided to keep Petitioner in existence and to have Petitioner purchase operating assets to manufacture electronics products, such purchase being made solely with Petitioner's balance of the proceeds of the sale of its coal assets and with its own credit. To the extent that Petitioner's 1951 net operating loss from the sale of its coal assets was not absorbed by carryback to 1950 or carryforward to 1952 and 1953, Petitioner claimed that loss as a deduction against its 1954 profits from the manufacture and sale of electronics products.

(B) In relevant detail the facts are these:

Petitioner was incorporated under the laws of the State of Illinois on July 20, 1886. Petitioner continuously existed as the same corporate entity under Illinois law from its incorporation until after the end of the calendar year 1954 which is the taxable year before this Court.

From incorporation until February 28, 1951, Petitioner was engaged in the mining and sale of bituminous coal and in related activities some of which were conducted through subsidiary corporations. The name of Petitioner initially was "The Consolidated Coal Company of St. Louis." On February 20, 1935, this name was changed to "The Consolidated Coal Company," which continued as Petitioner's name until April 15, 1953.

In the Fall of 1950, an attorney, representing a decedent's estate which owned the largest single block of Petitioner's only outstanding class of stock (approximately 26,032), approached the New York investment banking firm of Lehman Brothers and suggested the possibility that Lehman Brothers might acquire a controlling interest in Petitioner's stock.

Petitioner's shares were not listed on any exchange and were traded only over-the-counter. Said decedent's estate could not have sold its shares at any acceptable price in the over-the-counter market because actual sales were few and purchasers were not available. [Tr. 61; Stip. 5; Tr. 79-80]. The attorney for said decedent's estate was not trying to sell the estate's shares to Lehman Brothers. Rather he was trying to persuade Lehman Brothers that, by a proper approach and offering price, a controlling block of stock could be purchased, which controlling block could be resold as a whole at a profit. [Tr. 61, 70-72, 76, 78-79, 255, 259]. After investigation of the possibilities of reselling a controlling block of Petitioner's stock, Lehman Brothers decided to proceed, but only on a basis which did not involve any commitment to Petitioner's stockholders and did not involve any financial risk for Lehman

Brothers, except for expenses of making the requests for options as mentioned below. [Tr. 82-83, 85-86].

Lehman Brothers then made arrangements with Bankers Trust Company of New York under which Bankers Trust Company, acting on behalf of Lehman Brothers as undisclosed principal, solicited options to purchase shares of Petitioner. [Ex. 25-Y]. In response to said solicitation, Bankers Trust Company received for Lehman Brothers options covering more than 80 per cent of Petitioner's stock before the end of the year 1950 [Stip. ¶11] and subsequently received options on additional shares.

Lehman Brothers did not intend to exercise said options unless it first could find an immediate purchaser for the shares. [Tr. 82, 255].

After the foregoing options had been obtained by Bankers Trust Company, Lehman Brothers began to search for a buyer of Petitioner's shares which were subject to such options. Following several unsuccessful attempts, Lehman Brothers did locate a potential purchaser, which was Zeigler Coal & Coke Company (hereinafter called "Zeigler"), an Illinois corporation engaged in operating coal mines in Illinois.

Prior to the transactions herein described, none of the directors or officers of Petitioner held any stock, partnership, management, employee or other interest in either Lehman Brothers or Zeigler, and neither Lehman Brothers nor any partner therein, nor Zeigler nor any substantial stockholder of Zeigler had any significant ownership of shares of Petitioner. [Stip. ¶8, Ex. 19-S].

Lehman Brothers' desire was to sell the stock of Petitioner and the negotiations between Lehman Broth-

ers and Zeigler initially resulted in an agreement that Lehman Brothers would sell and Zeigler would buy the optioned shares at a price which would yield Lehman Brothers a profit of $200,000. Before this agreement was incorporated into a formal written contract, Zeigler notified Lehman Brothers that the agreement would have to be revised so that Zeigler would buy Petitioner's assets and not Petitioner's stock. Lehman Brothers thereupon advised that it would be agreeable to such revision, provided that Lehman Brothers would realize the same $200,000 profit, and provided also that Lehman Brothers would not have to bear any expense that it would not have borne had it sold the stock. Zeigler agreed.

Thereafter, the Zeigler directors refused to approve the proposed transaction. [Tr. 118-119, 97-98]. Further negotiations followed and Lehman Brothers was forced to agree to a further revision to eliminate its $200,000 profit and to substitute therefor a profit contingent on the amount which Zeigler might subsequently realize from the sale of certain of Petitioner's properties which Zeigler did not propose to retain (referred to as the "disposable properties"). As revised, the agreement was approved by the Zeigler directors. [Tr. 97, 119]. The revised agreement was incorporated into a written agreement. [Ex. 31-EE; Stip. ¶ 17].

Lehman Brothers thereupon instructed its agent, Bankers Trust Company, to exercise the options to purchase shares of Petitioner's stock on behalf of Lehman Brothers. Between January 29, 1951, and February 28, 1951, Bankers Trust Company purchased for Lehman Brothers 47,447 shares of the 49,994 shares outstanding [Stip. ¶ 16] or approximately 94.9 per cent of all shares outstanding.

Pursuant to requisite corporate action of its directors and stockholders, Petitioner on February 26, 1951, entered into an agreement with Zeigler whereunder Petitioner agreed to sell substantially all its assets to Zeigler, subject to liabilities, for the price and on the terms previously agreed upon by Lehman Brothers and Zeigler. [Ex. 34-HHH].

Both the agreement between Lehman Brothers and Zeigler [Ex. 31-EE] and the agreement between Petitioner and Zeigler [Ex. 34-HHH] required that Petitioner be dissolved at some time in the future after Petitioner had received all of the purchase price including Petitioner's contingent share in the proceeds of the disposable properties. These provisions were inserted at the insistence of Zeigler because Zeigler was assuming contingent and unknown liabilities of Petitioner, including possible subsidence claims based upon the subsurface excavator's absolute duty to provide support to the surface owner, and Zeigler had been advised by its counsel that such claims would be cut off unless asserted within two years following dissolution of Petitioner. [Tr. 100, 105-106, 120-121]. Accordingly, on February 26, 1951, the directors and stockholders of Petitioner took requisite corporate action to authorize dissolution and on February 27, 1951, Petitioner filed with the Secretary of State of the State of Illinois its Statement of Intent to Dissolve at some unspecified time in the future. [Ex. 33-GG; Ex. 34-HHH; Stip. ¶ 29; Ex. 44-RR; Ex. 45-SS].

On February 28, 1951, pursuant to the agreement of February 26, 1951, Petitioner sold and conveyed to Zeigler all of Petitioner's assets except cash and United States Treasury obligations and received in partial payment therefor the agreed assumption of liabilities

plus an amount of cash which together with Petitioner's retained cash and Treasury obligations equalled $3,900,000. [Stip. ¶ 31]. Petitioner's contingent share of the proceeds of the sales of disposable properties was payable on periodic future dates when Zeigler was required to account for any sales it had made.

Upon receipt of the cash at closing on the above-mentioned sale, the directors of Petitioner declared and on the same day Petitioner paid a partial liquidating dividend of $76.50 per share ($3,824,541 on 49,991 shares). Lehman Brothers utilized its share of the dividend ($3,629,695.50 on 47,447 shares) to repay bank loans which had been incurred to purchase the shares of Petitioner and incurred to pay certain cash brokerage commissions in connection with said purchase of shares.

In May of 1951, the directors of Petitioner declared and Petitioner paid a second partial liquidating dividend of $1.50 per share. On December 31, 1951, Lehman Brothers paid out an amount equal to its share of this dividend ($71,170.50 on 47,447 shares) to complete payment of the aforesaid cash brokerage commissions. [Stip. ¶ 37; Ex. 53-AAA].

In June of 1951, Petitioner's capital structure was altered by reducing the par value of its stock from $100 per share to $1 per share and thereby reducing its stated capital from $5,000,000 to $50,000. This amendment was undertaken at the request of Zeigler in order to reduce the franchise taxes of Petitioner which were an expense payable by Zeigler. [Tr. 113].

After February 28, 1951, and to the end of the year 1951, Petitioner did not engage in active commercial operations except that the collection and payment of accounts receivable and accounts payable which had

been purchased or assumed by Zeigler were conducted in Petitioner's name by employees paid at Zeigler's expense, and except that two directors of Petitioner had communications with the president of Zeigler urging that Zeigler speed up the sale of disposable properties so that Petitioner could collect any contingent payments which would become due. By the end of 1951, no amounts had as yet become due to Petitioner in respect of disposable properties.

Following the end of the year 1951, Zeigler made an offer to Petitioner to purchase Petitioner's interest in the disposable properties for $250,000. Petitioner accepted. Under date of March 26, 1952, Petitioner and Zeigler entered into a supplemental agreement whereunder Zeigler agreed to pay Petitioner $250,000 in full settlement of the balance of the purchase price under their agreement dated February 26, 1951, and Petitioner agreed that upon receipt of that payment it would "immediately take steps to dissolve." [Stip. ¶ 56; Ex. 75-WWW]. The payment was made and received immediately after execution of the supplemental agreement.

Petitioner sustained a loss on the above-described sale of its coal mining properties to Zeigler, as a result of which Petitioner sustained a net operating loss for the calendar year 1951 in the amount of $3,466,387.52.

Sometime *after* February 25, 1952, approximately a year after Petitioner's sale of its coal assets, when Petitioner's certified public accountants submitted a draft of 1951 Federal income tax return, the officers and directors of Petitioner and the partners and employees

[3] All relevant income tax and loss figures have been stipulated [Stip. ¶ 44].

of Lehman Brothers responsible for Lehman Brothers' investment in Petitioner *first* became aware that Petitioner had suffered a loss on the sale of its coal properties and that said loss might be a net operating loss eligible for carryback and carryforward. [Tr. 124, 132-137, 139, 150-151, 228, 230-232, 237, 241-242, 244-245, 257-259; Stip. ¶43; Ex. 58-FFF].[4]

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[4] Lehman Brothers had no tax purpose of any kind in purchasing shares of Petitioner. Although the Tax Court found it unnecessary to make the specific ultimate finding of fact that neither Section 129 of the 1939 Code nor Section 269 of the 1954 Code applied, the findings of fact permit only that conclusion.

The Tax Court made the following findings in the order in which they are set forth:

(1) "... Lehman Brothers began to search for a buyer of such stock in the event it should decide to exercise such options." Thus Lehman Brothers sought a buyer to which it could resell Petitioner's stock, and Lehman Brothers did not contemplate causing Petitioner to sell its assets.

(2) "Lehman Brothers' desire was to sell the *stock* of [Petitioner] ...." The italicization of the word "stock" is by the Tax Court, emphasizing its finding that Lehman Brothers thought only of a resale of Petitioner's stock, and clearly holding that Lehman Brothers never contemplated causing Petitioner to sell its assets, and that Lehman Brothers never contemplated continuing as a stockholder of Petitioner. In such circumstances, the loss now claimed by Petitioner would never have arisen as a part of any transaction contemplated by Lehman Brothers because that loss arose on Petitioner's sale of its assets; and, on re-sale of the stock, any tax benefit obtainable in respect of Petitioner's excess of tax basis for its assets over a price a purchaser paid for Petitioner's stock would inure to the benefit of the purchaser of Petitioner's stock from Lehman Brothers, not to Lehman Brothers as the seller of the stock.

(3) "... in [Lehman Brothers'] preliminary negotiations with Zeigler, an informal agreement was reached to sell the shares which [Lehman Brothers] had under option ...." Lehman Brothers' complete lack of any contemplation of other than a stock sale was confirmed by its actions.

(4) "Later, however, Zeigler indicated that it would be interested only in buying [Petitioner's] assets, and not the stock." A

The Internal Revenue Service, after examination of Petitioner's 1951 return and after full disclosure that Petitioner was contemplating reversing dissolution proceedings and resuming active operations [Ex.

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sale of assets by Petitioner was thought of and initiated by Zeigler for Zeigler's own purposes.

(5) "Lehman Brothers thereupon advised that it would be agreeable to such a revised transaction, provided that it could realize the contemplated $200,000 profit, and provided also that it would not have to bear any expense that it would not bear if it sold the stock." The form was a matter of indifference to Lehman Brothers provided it came out with the same net profit as on a stock sale to which it had already agreed.

(6) "In February 1951, a statement of intent to dissolve [Petitioner] was filed on behalf of that corporation with the Secretary of State of the State of Illinois." Petitioner's loss on the sale of its coal assets would have terminated had Petitioner's existence been terminated by dissolution so Petitioner's stockholders still had no knowledge of the loss and no thought of its use when such statement was filed.

(7) "March 14, 1951: 4,447 shares were transferred to Emmanuel Becker, the attorney who had suggested to Lehman Brothers the acquisition of the [Petitioner's] stock . . . . The shares so transferred to Becker were intended to assure to Becker 10 percent of whatever profit Lehman Brothers might realize in final liquidation of [Petitioner]." This is a finding that almost seven weeks after the initial written agreement between Lehman Brothers and Zeigler (Exhibit 31-EE, dated January 26, 1951; Stip. ¶ (17)) and two weeks after closing on Petitioner's sale of its coal assets to Zeigler on February 28, 1951, Lehman Brothers still thought solely in terms of final liquidation of Petitioner and thus solely in terms of a profit to arise if at all from Petitioner's agreed share of the proceeds of "Disposable Properties." Thus there was still no knowledge by Lehman Brothers that Petitioner's sale of its coal assets created a net operating loss and still no thought of the use of such loss.

(8) ". . . two of the directors of [Petitioner] had some correspondence with the president of Zeigler, wherein they urged that Zeigler proceed with greater speed to sell the above-mentioned 'disposable properties,' in the proceeds of which [Petitioner] was to share after the amount thereof had reached $800,000.

111; Ex. 112; Ex. 113], approved the loss as a net operating loss and granted a refund of 1950 taxes based on the carryback of part of the 1951 loss. [Ex. 112; Ex. 113; Ex. 114; Stip. ¶ 50; Ex. 69-QQQ]. Illinois counsel advised that under Illinois corporation law the dissolution proceedings could be "reversed and can-

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By the end of the year 1951 Zeigler had realized approximately $790,000 from the sale of about 55 percent of such disposable properties." Clearly throughout the year 1951 Lehman Brothers was anxious for Petitioner to get all its money in hand so the money could be distributed in final liquidation. By the end of 1951, then, Lehman Brothers still had no knowledge of Petitioner's net operating loss and no thought of the use of such loss. Dissolution of Petitioner was delayed by the necessity of awaiting full payment, not for any reason of Lehman Brothers. However, by the end of 1951 the sale of disposable properties had not proceeded far enough to entitle Petitioner to any share of the proceeds. The provision for dissolution of Petitioner applied after Petitioner received all of the purchase price including its entire share of proceeds of disposable properties. (Stip. ¶ (22) (d); Ex. 34-HH). Zeigler did not finally complete realization on the disposable properties until 1954 or 1955. (Tr. 130).

(9) Under the supplemental agreement dated March 26, 1952, Petitioner agreed it would "immediately take steps to dissolve."

(10) "The officers of [Petitioner], upon receipt of the above-mentioned $250,000, began to consider the possibility of not proceeding further with the dissolution of the corporation, but rather of having said corporation enter into some new type of business." As the Tax Court found, the said $250,000 was paid to Petitioner on March 26, 1952. It was only on and after that date—a year and two months after the initial written agreement between Lehman Brothers and Zeigler—that Petitioner and Lehman Brothers first began to consider resuming activities rather than dissolving.

These findings, which are adopted by Respondent, clearly negative any purpose or intent by Lehman Brothers to create or obtain any net operating loss when Lehman Brothers bought Petitioner's stock for resale.

celled out." [Tr. 159]. The Internal Revenue Service determined that the distributions previously made by Petitioner in partial liquidation would retain their character as capital distributions under Section 115(c) of the Internal Revenue Code of 1939 even if the dissolution proceedings were reversed and cancelled out and Petitioner resumed active operations other than coal mining. [Ex. 113; Ex. 114; Ex. 69-QQQ].

On or after April 14, 1952 [Tr. 131], Petitioner undertook negotiations with Zeigler to have Zeigler waive the requirement that Petitioner be dissolved. About a year later, on April 2, 1953, Petitioner and Zeigler entered into a Second Supplemental Agreement whereunder Zeigler waived the requirement that Petitioner be dissolved, and Petitioner re-assumed its subsidence and other liabilities as to which no actions were commenced by June 15, 1954. [Stip. ¶ 57; Ex. 77-YYY].

In the Spring of 1952, the officers of Petitioner also began searching for a profitable going concern which Petitioner might buy solely with its own cash and own credit. Sometime in the Fall of 1952, the officers of Petitioner began negotiations with a representative of the stockholders of a 3-member group of corporations, Ketay Manufacturing Corp., Kinetix Instrument Co., Inc., and Ketay Research and Development Corp. (hereinafter collectively referred to as the "Ketay Companies"). None of the stockholders of the Ketay Companies had any prior relationship with Petitioner or Lehman Brothers. The Ketay Companies were engaged in developing, manufacturing and selling precision electronic components. These negotiations culminated in an agreement dated April 6, 1953, whereby Petitioner agreed to purchase all the outstanding shares of each of the three Ketay Companies for a total con-

sideration of $2,725,000 (later amended to $2,750,000), payable $100,000 in cash at the closing date, with the balance payable in installments on or before March 1, 1958. The down payment came solely from Petitioner's own previously held assets and was part of the proceeds of Petitioner's sale of its coal assets. The deferred installments were solely the debts of Petitioner and were in no way guaranteed or assured by any stockholder of Petitioner or by any other person. Petitioner's purpose in buying the stocks of the Ketay Companies was to obtain the assets of the Ketay Companies.

Concurrently with the execution of the stock purchase agreement of April 6, 1953, Petitioner and the selling stockholders of the Ketay Companies entered into a second agreement whereunder Petitioner agreed it would increase the number of its authorized shares from 50,000 to 75,000 and that it would issue and sell (at a price of 5¢ each) to the Ketay stockholders warrants entitling them to purchase the additional 25,000 shares of Petitioner's common stock at a price of $4.95 per share.[5]

Preparatory to closing under the Ketay agreements, the following occurred. On March 30, 1953, the Secretary of State of the State of Illinois issued his certificate that Petitioner was still in Good Standing as a domestic corporation of the State of Illinois. On April 7, 1953, pursuant to applicable corporate procedures, the stockholders of Petitioner adopted a resolution that the voluntary dissolution proceedings, previously begun, should be revoked. On April 9, 1953, Petitioner

[5] The total of $5.00 per share was approximately equal to the underlying net assets value of Petitioner's shares at the time, i.e., the $250,000 in cash received from Zeigler divided by 50,000 authorized shares.

filed with the Secretary of State of the State of Illinois a "Statement of Revocation of Dissolution Proceedings," and said Secretary of State duly issued his Certificate of Filing thereof. Also on April 9, 1953, Petitioner amended its articles of incorporation (1) to expand its purposes, (2) to increase its authorized number of shares from 50,000 to 75,000, and (3) to abrogate pre-emptive rights.

On April 15, 1953, closing took place under the aforesaid agreements between Petitioner and the Ketay stockholders, and Petitioner thereupon acquired all of the outstanding capital stock of all three Ketay Companies. Immediately thereafter, on the same day, Petitioner caused each of the Ketay Companies to file its certificate of dissolution with the Secretary of State of the State of New York. Also on the same day Petitioner changed its name to "Ketay Manufacturing Corp." On the following day, April 16, 1953, the Secretary of State of the State of New York dissolved all three Ketay Companies, and Petitioner thereupon became the owner of all assets and properties previously owned by the Ketay Companies.[5] Petitioner's principal office became New York City. Following April 16, 1953, and until July 1, 1958 [Stip. ¶ 80], Petitioner continuously engaged in substantially the same activity as had previously been conducted by the Ketay

[5] Petitioner purchased the stock of the Ketay Companies solely to get their assets, and Petitioner immediately dissolved the Ketay Companies and got direct ownership of their assets. Petitioner is to be treated for all purposes as having purchased the assets of the Ketay Companies. *Kimball Diamond Milling Company*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951); *United States* v. *M. O. J. Corporation*, 274 F.2d 713 (5th Cir. 1960).

Companies, i.e., the development, manufacture and sale of precision electronic components.

On August 31, 1953 [Stip. ¶ 70; Ex. 101-BAW], all of the above-described stock warrants which had been issued to the former Ketay stockholders were exercised by them or by others to whom the warrants had been transferred.

On November 2, 1953, Petitioner's authorized common stock was changed and increased from 75,000 shares of $1 par value to 850,000 shares of 10¢ par value and each existing share became 10 new shares. On June 22, 1954, Petitioner's authorized common stock was increased to 2,000,000 shares. On September 10, 1954, Petitioner's name was changed to "Ketay Instrument Corporation." On September 29, 1954, 300,000 shares of Petitioner (consisting in part of authorized but unissued shares being sold by Petitioner and in part of issued shares being sold by stockholders[7]) were sold to the public through underwriters. On February 11, 1955, following a merger which is not in question here, Petitioner changed its name to "Norden-Ketay Corporation."

As stipulated [Stip. ¶ 44], for 1951 Petitioner had a net operating loss of $3,466,387.52, arising from its previous activity of mining and selling bituminous coal. Of this loss, the amount of $207,839.15 was absorbed by carryback to 1950. For 1952, Petitioner had a net operating loss of $5,869.02. For 1953, Petitioner had adjusted net income of $1,108,410.66, before net operating loss carryforward, all of which net in-

[7] The shares sold were not, as recited by the Tax Court below, all newly authorized shares being sold by Petitioner. [Ex. 104-BAZ; Stip. ¶ 76].

come arose from the manufacture and sale of electronic components following Petitioner's purchase of assets of the Ketay Companies. The 1953 electronics income was offset by an equal amount of the 1951 coal loss carryforward, and Petitioner's 1953 return is not in question. Petitioner's balance of unused 1951 coal loss available for carryforward to 1954 is $2,150,137.71 which exceeds Petitioner's stipulated electronics income for 1954 before net operating loss carryforward.

VI. REASONS FOR GRANTING THE WRIT

This petition for certiorari should be granted because:

(A) the decision of the Court of Appeals for the Second Circuit is in direct conflict with the decision of the Court of Appeals for the Ninth Circuit on indistinguishable facts in *Hawaiian Trust Company, Limited* v. *United States*, 291 F.2d 761 (9th Cir. 1961); and the decision of the Court of Appeals for the Second Circuit in the present case reaches that conflicting position because the Court of Appeals completely misconstrues and misapplies the decision of this Court in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382 (1957); and because

(B) the issue is of current importance to corporate taxpayers generally and the conflict and confusion fostered by the decision of the Court of Appeals for the Second Circuit in the present case should be resolved and clarified by this Court.

(A)

The decision of the Court of Appeals for the Second Circuit in the present case is in direct conflict with the decision of the Court of Appeals for the Ninth Circuit

on indistinguishable facts in *Hawaiian Trust Company, Limited* v. *United States, supra*.*

In *Hawaiian Trust*, a corporation referred to as Refiners purchased 96 per cent of the stock of Hilo Gas during October of 1950, pursuant to options previously acquired. Refiners had no tax avoidance purposes of any sort for the acquisition. On October 31, 1950, pursuant to earlier arrangements, Hilo Gas sold its utility assets, which were substantially all its assets, to Honolulu Gas; a corporation the stockholders of which appear to have been substantially the same as the stockholders of Refiners. Honolulu Gas also assumed the liabilities of Hilo Gas. Some remaining assets were sold to Refiners at the same time. Thereafter, Hilo Gas, with only insignificant exceptions, had only the proceeds of the sales, most of which were lent to its new parent Refiners, and no liabilities.

At the time Refiners purchased the stock of Hilo Gas, it was intended and arranged to sell the public utility assets of Hilo Gas to Honolulu Gas, to sell the remaining assets to Refiners, and "to dissolve the corporation [Hilo Gas] at such time as the directors of that company determined in their discretion to be convenient." In November, 1950, the month *following* acquisition of the Hilo Gas stock and the sale of the Hilo Gas assets, Refiners was advised that the sale by Hilo Gas of its utilities properties to Honolulu Gas resulted in an allowable net operating loss. Thereafter, Hilo Gas was kept in existence and its loss used

* Petitioner argued and briefed the *Hawaiian Trust Company* case to the Court of Appeals for the Second Circuit and again pointed to the case in a Petition for Rehearing but the Court of Appeals for the Second Circuit declined to attempt to distinguish the case and did not even cite it.

as a net operating loss carryforward on consolidated returns filed by Refiners and Hilo Gas. From the sale of its assets in 1950 until its dissolution in 1956, Hilo Gas had no significant commercial activities. The loss of Hilo Gas was suffered on the sale of its assets used as a regulated public utility which manufactured and distributed gas through mains. The income of Refiners for 1953, against which the 1950 loss of Hilo Gas was claimed as a carryforward deduction, arose from an entirely different commercial activity as a non-public utility refining and selling petroleum products and selling bottled gas.

In *Hawaiian Trust*, the Court of Appeals for the Ninth Circuit held the loss allowable. On indistinguishable facts in the present case, the Court of Appeals for the Second Circuit held the loss not allowable.

(1) The Court of Appeals for the Ninth Circuit deemed it irrelevant that the loss which arose from one type of commercial activity was offset against income from another type of activity; this was the "first and most obvious factor" in the conflicting decision in the present case.

(2) The Court of Appeals for the Ninth Circuit deemed it irrelevant that there had been a 96 per cent change in stock ownership *prior* to the time the loss arose, since the change in stock ownership was not undertaken by the purchaser for any tax avoidance purpose; the Court of Appeals for the Second Circuit, in its conflicting decision in the present case found that a 94.9 per cent change in stock ownership *prior* to the time the loss arose was "the second major factor" in its disallowance of the loss even though the change of stock ownership was not undertaken by the purchaser for any tax avoidance purpose.

(3) The Court of Appeals for the Ninth Circuit held that the only question was whether Refiners' acquisition of the Hilo Gas stock was for a tax avoidance purpose and further held that post-acquisition events were not relevant. Thus the Court of Appeals for the Ninth Circuit found it irrelevant that it had been intended to dissolve Hilo Gas, that steps to dissolve Hilo Gas had been initiated and that Hilo Gas had no significant commercial activities, as well as finding that it was irrelevant whether the income against which the loss was used arose from the same activity as the loss. The Court of Appeals for the Second Circuit in its conflicting opinion in the present case held that all these same post-acquisition events could support its disallowance of the loss even though Lehman Brothers' acquisition of Petitioner's stock was not for a tax avoidance purpose.

(4) The Court of Appeals for the Ninth Circuit held that the tax benefit innocently acquired by Refiners in its purchase of stock of Hilo Gas, even if called a "windfall", was properly allowable even though the decline in value of the Hilo Gas assets may have occurred prior to Refiners' purchase of the Hilo Gas stock so that the loss was borne by the sellers of the stock; the Court of Appeals for the Second Circuit in its conflicting opinion in the present case held that the tax benefit innocently acquired was not allowable, even though plainly within the statute, and gave as a reason that the "ultimate incidence" of the loss did not fall on Lehman Brothers as purchasers of the stock after the decline in value of the coal assets must have occurred.

These are the operative points of decision in the two cases and the two decisions squarely conflict. This conflict should be resolved.

The Court of Appeals for the Second Circuit reached its conflicting position in the present case because it completely misconstrues and misapplies the decision of this Court in *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957). The stated grounds of the Court of Appeals below are some new kind of *Clifford*[9] doctrine involving a compound of an undeterminable number of degrees of change in the nature of corporate activity, and an unspecifiable number of percentages of change in ownership of stock—a test incapable of statement except in the vaguest generalities. As precedent the Court of Appeals for the Second Circuit cites this Court's decision in *Libson Shops*.

It is submitted that the *Libson Shops* decision had nothing whatever to do with either the nature of the corporate activities or any changes therein, or with any ultimate beneficial ownership of stock or changes therein. At the outset it should be noted that in *Libson Shops* exactly the same commercial activities were carried on continuously at all relevant times and the ultimate beneficial ownership of stock was exactly the same at all relevant times. The unchanging continuance of the same activities and of the same stock ownership did not save the loss in that case because neither had anything to do with that case.

In *Libson Shops* this Court was required to determine whether and under what circumstances a net op-

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[9] *Helvering* v. *Clifford*, 309 U.S. 331 (1940), taxing to the grantor the income of a short term trust because his retained powers and retained "bundle of rights" were found to constitute retention of dominion and control and substantial ownership. Much litigation followed. Congress has now overruled *Clifford* and prescribed a set of specific and objective tests. Internal Revenue Code of 1954, Sections 671-677.

grating loss of a constituent corporation would be available as a carryforward loss to the surviving corporation after a tax-free merger. The previous decisions of this Court and the lower courts, in some cases concerning net operating losses and in some cases concerning other kinds of tax characteristics, had developed three possibilities: (1) that a loss carryforward never survived regardless of the form of corporate amalgamation;[10] (2) at the opposite extreme, that a loss carryforward always survived a tax-free merger, regardless of the previous relationship or lack of relationship of the constituent corporations;[11] and (3) in the middle, that a loss carryforward survived a tax-free amalgamation provided that the constitutent corporations had previously been related (parent-subsidiary or so affiliated that consolidated returns could have been filed) and provided that the loss arose while the constituent corporations were so related.[12]

The *Libson Shops* case presented to this Court only the question of which of these three possibilities was the proper application of the law to find the identity of

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[10] Based on *New Colonial Ice Company* v. *Helvering*, 292 U.S. 435 (1934).

[11] Based on *E. & J. Gallo Winery* v. *Commissioner*, 227 F.2d 699 (9th Cir. 1955), *rev'g* 12 CCH TCM 414, 22 P-H TCM ¶ 53,131 (1953).

[12] Based on *Helvering* v. *Metropolitan Edison Company*, 306 U.S. 522 (1939); *Koppers Company, Inc.* v. *United States*, 134 F. Supp. 290 (Ct. Cl. 1955), *cert. denied*, 353 U.S. 983 (1957); *The Stanton Brewery, Inc.* v. *Commissioner*, 176 F.2d 573 (2d Cir. 1949); *Hughes Tool Company* v. *Commissioner*, 147 F.2d 967 (5th Cir. 1945); *Early* v. *Southgate Corporation*, 136 F.2d 217 (4th Cir. 1943); see also *Newmarket Manufacturing Company* v. *United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957).

"the taxpayer" which was entitled to a carryforward of its own loss.

In the *Libson Shops* case there had been 17 separate corporations, all of the outstanding stock of which was owned directly or indirectly by the same 8 individuals and in the same proportions. The corporations were not in the relationship of parent and subsidiaries, nor were they so affiliated as to be entitled to file consolidated returns. Sixteen of the corporations were engaged in selling women's apparel at retail at different locations. The other corporation acted as the management corporation. Pursuant to a statutory merger, all 17 corporations were merged and the former management corporation was the emerging corporation. Following the merger, the emerging corporation continued to conduct the same commercial activities as had previously been conducted by all of the constituent corporations and at the same locations. Prior to the merger, three of the sales corporations had sustained net operating losses and in the year following the merger each of the three retail units formerly operated by these three loss corporations continued to show losses, although the total operations of the emerging corporation showed a profit. The emerging corporation claimed the deduction by carryforward against post-merger profits of the pre-merger net operating losses of the three loss constituent corporations. The sole question presented to this Court was whether the emerging corporation was the same "taxpayer" as its pre-merger loss components so as to be entitled to carryforward against post-merger profits "its" pre-merger losses.

The primary contention of the Government was that separately chartered corporations are never the same

taxable entity as the emerging corporation could not be the same "taxpayer" as its submerged loss constituents—the first of the three possibilities mentioned above. The primary contention of the taxpayer was that a corporation resulting from a tax-free statutory merger is always the same taxable entity as its constituents without regard to the pre-merger relationships because the corporate existence of all constituent corporations continues within the emerging corporation—the second alternative to the opposite extreme from the first. This Court found it unnecessary to discuss the issue created by these primary contentions of the parties because this Court adopted the third possibility, the middle ground, as the correct rule.

Thus this Court held that, following a tax-free merger, the emerging corporation would be the same "taxpayer" as the constituent corporations, for purposes of carrying forward pre-merger losses against post-merger profits, if (and only if), prior to the merger and during the time the losses arose, the constituent corporations had been parent and subsidiaries or so affiliated as to be entitled to file consolidated returns. Under such circumstances, pre-merger there would have been a single "pool" of stockholder risk insofar as the ultimate stockholders were concerned, in which case this Court viewed revisions in the number of corporate entities within that single pool as irrelevant, and the single "pool" remained a single "taxpayer" even though the number of corporate entities within that pool were reduced by merger. That single "pool" of ultimate stockholder risk would be "a continuous enterprise" and there would be a "continuity of business" even though the number of corporate sub-pockets were changed. On the other hand, if pre-merger there

were multiple pools of stockholder risk, i.e., the constituent corporations were not parent-subsidiary and were not affiliated for consolidated return purposes, this Court held that the stockholders should not retroactively be able to rearrange their affairs so as to be able to put into a single pool their profits and losses which had arisen in separate pools. In *Libson Shops*, there had been multiple pre-merger pools, so the emerging corporation was not the same "taxpayer" as its constitutents and could not use their pre-merger losses.

This holding of *Libson Shops* and the distinction made are entirely sound. At the outset, the organizers in *Libson Shops*, having decided to operate in corporate form, had alternatives as to how to set up their organization. Each alternative had its Federal income tax advantages and its Federal income tax disadvantages.

On the one hand, they could have conducted all operations through a single corporation or through a parent and wholly-owned subsidiaries. In this case, funds from a profitable store could be used to finance a losing store or to start a new store without those funds having to be transferred first as taxable dividends to individual stockholders and then as contributions to capital. Losses of one store could be deducted currently against profits of other stores if there were a single corporation or if the parent and subsidiaries filed a consolidated return. However, the single corporation or the parent and subsidiaries filing a consolidated return would be entitled to only a single $25,000 corporate surtax exemption and all net profits over $25,000 would then be subject to both corporate normal tax and corporate surtax the combined rate of which is presently 52 per cent. Also, if, for example,

one store were sold, a corporate tax on the profit could not be avoided without a corporate liquidation of the whole enterprise, which would require a tax at that time on all increment in value of the total enterprise; and, absent a liquidation, the proceeds of the sale of one store could only be distributed as a dividend and not as a capital gain unless the total enterprise had no earned surplus.

On the other hand, the organizational form adopted, of individual stock ownership of a number of corporations each having one store, achieved the opposite tax result on each of the above points. The advantages above were disadvantages: funds could not be moved from one store to another except after being paid out as taxable dividends to the individual stockholders; losses of one corporation could not be deducted currently against profits of another corporation and could be deducted by carryback or carryforward only against any prior or subsequent profits of that loss corporation. At the same time, each separate corporation had its own $25,000 surtax exemption so that the 17 corporations in total could have profits of $425,000 taxable only at the normal tax rate (now 30 per cent) before getting into corporate surtaxes (another 22 per cent). Also, if one separate store were sold, that separate corporation would not have to pay any tax on its profit, and it could be arranged that there would be only a single tax at capital gains rates when those proceeds were distributed to the individual stockholders. The organizers in *Libson Shops* sought these advantages and accepted the disadvantages.

If, solely because of the merger, *Libson Shops* had permitted a post-merger deduction of pre-merger losses, the stockholders would thereby retroactively

have achieved a netting of profits and losses which was not allowable under the organizational form originally selected. A merger alone should not retroactively create such a tax advantage. Congress certainly cannot have intended any result except the precise result achieved by this Court in *Libson Shops*.

But the *Libson Shops* opinion had nothing whatsoever to do with the nature of the commercial activities or with the ultimate beneficial stock ownership. Both remained unchanged across the line of corporate merger in *Libson Shops* yet this unchanging continuance did not save the *Libson Shops* loss since neither had anything to do with the case. *Libson Shops* is incorrectly cited for any proposition concerning the nature of or any change in commercial activities or ultimate beneficial stock ownership. The "test" conjured by the Court of Appeals for the Second Circuit below is groundless.

The Court of Appeals for the Second Circuit misreads *Libson Shops* as establishing and supporting an "activities—stock ownership" test despite the fact that this Court in its *Libson Shops* opinion went out of its way to specify that that opinion had nothing to do with any such possible test. In footnote nine to the *Libson Shops* opinion (353 U.S. at 390), this Court stated:

> "We do not pass on situations like those presented in *Northway Securities Co.* v. *Commissioner*, 23 B.T.A. 532; *Alprosa Watch Corp.* v. *Commissioner*, 11 T.C. 240; *A. B. & Container Corp.* v. *Commissioner*, 14 T.C. 842; *W & G E, Inc.* v. *Commissioner*, 19 T.C. 249. In these cases a *single* corporate taxpayer changed the character of its business and the taxable income of one of

its enterprises was reduced by the deductions or credits of another."

It is unquestionably clear that this Court did *not* pass on and made *no* holding with respect to the *only* point for which the Court of Appeals in the present case cites *Libson Shops* as precedent! And without the Court of Appeals' erroneous view of *Libson Shops*, there is no precedent or substantiation for the decision in the present case.

(B)

The issue is of current importance to corporate taxpayers generally and the conflict and confusion fostered by the decision of the Court of Appeals for the Second Circuit in the present case should be resolved and clarified by this Court. The issues of the conflict with *Hawaiian Trust* and the erroneous construction and application of *Libson Shops* are squarely presented here, are of broad interest, and of major current importance.

There is widespread confusion. The meaning of the *Libson Shops* decision is plain as discussed above, but the imprecise language at points in that opinion permitted some uncertainty. This Court's use of the words "business" and "businesses" did not make it clear which of a great many possible meanings was intended for each word. The Commissioner of Internal Revenue, with considerable unanalytical indulgence of some courts, has then taken these words out of context to create muddled arguments about some "principle" precluding a change in the nature of commercial activities. The Commissioner is not certain what he thinks that "principle" is, or at least is not consistent in defining or applying it, but he is certain he has something which is a fine club.

The Commissioner's misuse of this Court's opinion is not justified, but—in the unlikely event that any such development as this could have been foreseen at the time—if this Court's opinion in *Libson Shops* had been tightly written with precise words, there would have been no starting point for all this confusion.

The Commissioner's first pronouncement, somewhat more than a year after this Court's decision, was that the "principle" of *Libson Shops* "will not be relied upon by the Internal Revenue Service under the Internal Revenue Code of 1954 . . ." *Rev. Rul. 58-603*, 1958-2 Cum. Bull. 147 (TIR 89, 8-25-58) [App. p. 38a]. However, despite the Commissioner's announcement, his representatives in the examination of returns and the argument of cases did not confine their arguments about the "principle" of *Libson Shops* to 1939 Code cases, but have applied their "principle" equally to all years including 1954 Code years.

The Commission's representatives also considerably extended the Commissioner's originally announced view as to the "principle" of *Libson Shops*. In *Rev. Rul. 59-395*, 1959-2 Cum. Bull. 475 [App. pp. 38a-45a], the Commissioner expressed his view as (1) that no carryforwards or carrybacks were allowable across the line of a corporate fusion effected other than by a statutory merger or consolidation and (2) that in cases of statutory mergers or consolidations only the income and losses from the same *assets* could be netted —two astonishing conclusions to draw from *Libson Shops*. But even this "principle" expanded rapidly and the necessity for any form of corporate fusion was soon dropped. The position became that, without any corporate fusion of any sort, and with only a single corporate taxpayer, losses could be offset only against

income of the same assets that produced the loss—nothing else was required for the Commissioner to deny the loss except the fact that the physical sources of the loss and the profit were not the same. Allegedly *Libson Shops* was authority for this view.

This argument, in various stages of its development, has been made to lower courts by the Commissioner's representatives. Until the present case, the lower courts seem generally to have achieved the right result, but the courts on occasion have included some of the language by which the Commissioner's representatives represented the *Libson Shops* holding as concerning a change in the nature of commercial activities and later as also concerning changes in stockholdings.

Encouraged by the language in some of these opinions, the Commissioner's representatives have pushed their version of *Libson Shops* to the extreme. For example, a loss corporation invested part of its assets in stock of a non-controlled corporation, apparently a passive investment. The Appellate Division refused to allow the loss carryforward against dividend income. *Tax Management Memorandums*, July 9, 1962, p. 6. A manufacturing corporation sold all operating assets after suffering severe financial losses and invested the proceeds in a joint venture conducting a service activity. The Internal Revenue Service denied the carryforward deduction. *Tax Management Memorandums*, September 3, 1962, p. 5.

The positions advanced became so extreme that the Section of Taxation of the American Bar Association felt it necessary to recommend a specific amendment to Section 172 of the 1954 Code, which relates to net operating loss carrybacks and carryforwards, to pro-

vide that "the amount of the [net operating loss] deduction . . . for any taxable year shall not be reduced by reason of the fact that the net operating loss carryovers and carrybacks to such year are attributable in whole or in part to activities different from the activities carried on during such taxable year." The Section of Taxation proposed that such specific amendment should be made retroactive to all 1954 Code years because of "the evident intent of Congress in enacting the 1954 Code that a continuity of business enterprise test should not be applicable except in situations covered by § 382(a)." *Program and Committee Reports, 1962*, Section of Taxation, American Bar Association, pp. 47-49.

Early this year the Commissioner retreated slightly from the extreme position that, without more, losses from one set of assets or activity could be netted only against income from the same set of assets or activity. The "principle" of *Libson Shops* could hardly have changed, but, borrowing the general approach of Congress in Section 382(a) of the 1954 Code, the Commissioner now says that, under the alleged authority of *Libson Shops*, and for a single corporation even in the absence of any merger, where there is "more than a minor change in stock ownership", a loss may not be carried forward against the income of a "new business activity." *Rev. Rul. 63-40*, 1963-12 Int. Rev. Bull. 8 (TIR 456, March 4, 1963) [App. pp. 45a-48a]. The scope of application of the Commissioner's statute is precisely the same as the act of Congress, yet the Commissioner gets different results.

The Commissioner's new "principle" is stated to be applicable to all 1954 Code years, as a part of some

common law of Federal income taxation. *Rev. Rul. 63-40*.

Rev. Rul. 63-40 is legislation by the Commissioner in direct competition with Congress' statute on the same subject. The Court of Appeals in the present case adopted the Commissioner's statute to disallow Petitioner's loss which loss would not have been disallowed by Congress' statute.

In Section 382(a) of the Internal Revenue Code of 1954, Congress provided specific rules under which net operating loss carryforwards otherwise allowable under the general statutory provisions should nevertheless be disallowed. Congress was well aware of the problems created (and later cured) by certain court decisions[18] under Section 129 of the 1939 Code and Section 269 of the 1954 Code relating to acquisitions where there was a principal purpose of tax avoidance [App. pp. 32a-35a], and Congress was also aware of problems of proving the subjective intent required by those Sections. So, in the 1954 Code, after providing in broad terms for net operating losses (and other tax attri-

[18] Originally it had been held that, even where the new stockholders conceded that they acquired the stock of an empty shell loss corporation only to get the loss, Section 129 of the 1939 Code did not disallow the loss to the corporation, the ground being that Section 129 applied only to an acquiring and not to an acquired corporation. *See Alprosa Watch Corporation*, 11 T.C. 240 (1948); *British Motor Car Distributors, Ltd.*, 31 T.C. 437 (1958). The Court of Appeals for the Fifth Circuit held contrary to the Tax Court on this point in *Mill Ridge Coal Company* v. *Patterson*, 264 F.2d 713 (1959), *cert. denied*, 361 U.S. 816 (1959), and the Court of Appeals for the Ninth Circuit then reversed the Tax Court in *British Motor Car Distributors*, 278 F.2d 392 (1960). The Tax Court accepted the new rule in *Thomas E. Snyder Sons Co.*, 34 T.C. 400 (1960), *aff'd*, 288 F.2d 36 (7th Cir. 1961). But *Alprosa Watch* was the decisional law when the 1954 Code was enacted.

butes) to continue to be available generally following innumerable types of transactions, Congress then set forth specific rules for disallowance, despite the general rules and without regard to whether there was any tax avoidance purpose, in cases where Congress found that there might be possibilities of unintended uses of losses. Thus, in 382(a) of the 1954 Code, Congress provided that, if there were the specified percentage change in stock ownership of a corporation, and if the "trade or business" of that corporation underwent the specified change within the specified period, net operating losses from prior years would not be allowed.

Rev. Rul. 63-40 covers precisely the same subject matter and uses the same approach, but the Commissioner disagrees with Congress as to the standards. Thus Congress requires at least a 50 percentage points change in stock ownership within a period of two taxable years; the Commissioner questions "more than a minor change in stock ownership" without any specified percentage and without any time limitation. Congress requires that there be the specified change in the trade or business prior to the end of the taxable year following the taxable year of change of stock ownership; the Commissioner requires only that there be a "new business enterprise" which might be of the same nature as or in addition to or in place of that previously operated, and the Commissioner has no time limit. Congress felt it necessary to deal only with losses arising in the year of change of stock ownership and years prior thereto; the Commissioner looks at losses thereafter arising before the acquisition of the "new business enterprise."

It is respectfully submitted that, when Congress and the Commissioner legislate on the same subject, the

act of Congress occupies the field. And the statute as enacted by Congress would not disallow this Petitioner's loss."[11]

This Petition does not ask this Court to assist tax avoidance or trafficking in tax losses. To the contrary, this Court is asked to correct an erroneous "doctrine" which started with a misreading of a few words in the *Libson Shops* opinion and which with careful nourishment by the Commissioner has ballooned into a vigorous statute competing effectively with an act of Congress. The Commissioner, with the tolerance of some lower courts, such as the Court of Appeals in the present case, has injected uncertainty into numberless legitimate commercial transactions on the precise points where Congress by express legislation intended to provide certainty. Even tax "experts" are unable to advise businessmen with any assurances as to what the Commissioner's position is or will be next.

Net operating losses do not *per se* involve tax avoidance. In the overwhelming number of instances the

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[11] Under Section 394(b), 1954 Code, 68A Stat. 13f, Aug. 16, 1954, Section 382(a) does not apply in respect of changes of stock ownership prior to June 22, 1954, even though, as in the present case, a loss carryforward is claimed under the 1954 Code. However, even if Section 382(a) had been fully effective for all years possibly relevant to the present case, Section 382(a) would not have disallowed Petitioner's claimed loss. Section 382(a) disallows only losses arising in the year of change of stock ownership and in years prior thereto. This Petitioner's loss arose in its taxable year 1953 which was the year following the taxable year 1950 in which by options (Section 382(a)(3), Section 318(a)(3)) Lehman Brothers acquired over 80 per cent of the stock of Petitioner. Also in 1953 and 1954, when Petitioner operated the assets purchased from the Ketay Companies, there was not a change in stock ownership of as much as 50 percentage points as required by Section 382(a).

aims of Congress are plainly achieved to provide, under our annual accounting system for income taxes, an income averaging for enterprises with cyclical or sporadic income. New enterprises have starting-up losses; existing enterprises experience losses when expanding in the same or different lines; some enterprises, particularly capital goods industries, are cyclical. Many companies by adopting the Treasury's new depreciation guidelines (*Rev. Proc. 62-21*, 1962-2 Cum. Bull. 418) and by using faster methods of depreciation (Section 167(b)(2), (3) and (4) of the 1954 Code)—both designed to encourage plant renovation and development of new industrial activities—may frequently create net operating losses. Congress, in defining the net taxable income of these enterprises for annual accounting purposes, provided for carrybacks and carryforwards to achieve an averaging. For example, in the Revenue Act of 1939, Congress provided for a two-year carryforward of net operating losses, explaining in part:

> "New enterprises and the capital-goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carry-over will greatly aid business and *stimulate new enterprises*." *H.R. Rep. No. 855*, 76th Cong., 1st Sess. 9 (1939) (emphasis added).

The Revenue Revision Act of 1948 amended the net operating loss provision to provide for a one-year carryback and a five-year carryforward, which changes were explained in part:

> "This reduces the tax disadvantages of businesses with fluctuating incomes. Since these incomes are associated with unusual business risks and occur

"with relatively great frequency among small and *new businesses*, the extension of the averaging period will provide an *additional stimulus to venture capital generally*. . . .

". . . The emphasis on the carryforward is to the marked advantage of *new business*. . . . *Established businesses undergoing a material expansion are favored by the change*." *H.R. Rep. No. 2087*, 80th Cong., 2d Sess. 2-3 (1948) (emphasis added).

There is no suggestion here that a loss from one type of activity could be netted only against income of the same activity. Rather losses would offset income of "new enterprises" and of "material expansion" whether in the same or a different activity.

This is particularly important today with many enterprises bearing high research and development costs and many experiencing heavy costs from rapid obsolescence. An explosives manufacturer today would not be encouraged as Congress intends to undertake heavy research and development costs to create new products such as nylon if losses from research and development could not be offset against income from nylon which is primarily used for clothing and fabrics. Yet, if the company's stock is listed and traded on a stock exchange with "more than a minor change in stock ownership" over some unspecified period, *Rev. Rul. 63-40*, the Commissioner's statute would kill the loss. Congress' statute would allow the loss unless there were a new more-than-50 per cent controlling group of ten stockholders which group acquired that control within a specified limited period. A manufacturer of propeller-driven manned airplanes could not afford to scrap his obsolete equipment and make heavy investments in equipment to manufacture rockets if

his loss on the scrapping of the old machines could not be set off against income from manufacture of rockets. Yet, if there were "more than a minor change in stock ownership" even for a listed company, the Commissioner's statute, *Rev. Rul. 63-40*, would disallow the loss.

Congress provided broadly for loss carrybacks and carryforwards and for such losses to survive many types of corporate transactions. Then, in Sections 382 and 269, Congress dealt specifically with those cases in which, after careful study, Congress determined that allowance of the loss would not accord with Congressional policy. Congress has specifically drawn the lines, and has not left the line-drawing either to the Commissioner or to the Courts. The separate and different rules of the Commissioner, applied as in the present case by the Court of Appeals for the Second Circuit, are unwarranted.

VII. CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX

I. OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

SMITH, *Circuit Judge:*

Prior to 1951, petitioner was an established Illinois corporation primarily engaged in the business of mining coal under the name Consolidated Coal Corporation. During 1950, overtures to Lehman Bros., a New York investment banking firm, had been made on behalf of the owners of the principal block of stock, with a view towards sale of the stock. Lehman Bros. located a buyer, the Ziegler Coal & Coke Company, which, however, as matters finally developed was interested only in purchasing the assets of Consolidated. The following transactions then took place: Lehman Bros. exercised the purchase options it had secured through an agent and became the owner of nearly 95% of the outstanding stock on February 28, 1951; on the same day Consolidated conveyed all its assets except cash and Treasury obligations to Ziegler in return for $3,900,000 cash and Ziegler's promise to pay 50% of all amounts received over $800,000 for certain "disposable properties" conveyed by Consolidated which were to be sold. Immediately on receipt of the cash payment, the directors of Consolidated declared a partial liquidating dividend nearly equivalent to the amount of the payment. This, of course, went mainly to Lehman Bros. At the same time, Consolidated filed a statement of intent to dissolve with the Illinois Secretary of State. Consolidated had sustained a loss on the sale of the assets of $3,509,043.57 and a net operating loss of $3,466,387.52 for 1951.

Consolidated remained dormant throughout 1951 and early 1952, declaring a further dividend in partial liquidation during this period. In March of 1952, Ziegler liquidated Consolidated's interest in the disposable properties for $250,000 cash, the agreement also requiring that Consolidated immediately take steps towards dissolution. Instead,

the Consolidated directors began to search for some new field of endeavor which the corporation might enter. This quest culminated on April 6, 1953 in the purchase of the stock of three closely-held corporations, Ketay Manufacturing Corporation, Kinetix Instrument Company, and Ketay Research & Development Company (hereafter called the Ketay Companies), engaged in the manufacture and sale of precision electronic equipment. The total consideration was $2,275,000, later increased by $25,000, of which $100,000 was payable as a cash down payment and the balance in instalments over the next five years. The restrictive agreement with Ziegler was cancelled by mutual consent at about this time. Consolidated changed its name to Ketay Manufacturing Corporation, dissolved the three Ketay Companies, and took over their assets and management. The stockholders of the three companies were allowed to purchase newly issued Consolidated-Ketay stock, which they all did, and all of them remained as officers or directors of Consolidated-Ketay.

The corporation reported taxable income for 1954 from its electronics business of $1,007,623.38 before net operating loss deduction. It carried over a net operating loss from 1951 of $2,304,125.58 which had resulted principally from the sale of the coal-mining assets. After deducting this loss, the corporation reported a net loss for 1954 of $1,296,502.20. The Commissioner of Internal Revenue, by his notice of deficiency, disallowed the claimed net operating loss deduction. Petitioner seeks review of the decision of the Tax Court sustaining the asserted deficiency.

The applicable law is to be found in the Internal Revenue Code of 1939. See I. R. C. of 1954 § 172(g)(1). The particular provision that governs is I. R. C. of 1939 § 122, and the leading interpretation of the provision is to be found in the opinion of the Supreme Court in *Libson Shops* v. *Koehler*, 353 U. S. 382 (1957). Application of the principles of that decision to the facts of the present case lead us

to conclude that the decision of the Tax Court must be affirmed.

The precise question in *Libson Shops* was whether "a corporation resulting from a merger of 17 separate incorporated businesses, which had filed separate income tax returns, may carry over and deduct the pre-merger net operating losses of three of its constituent corporations from the post-merger income attributable to the other businesses." 353 U. S. at 382. Sixteen sales corporations had been merged into a management company without change in the actual business carried on by any of them. As the Supreme Court interpreted the statute, the legal problem upon which the case turned was the interpretation of the operative words "the taxpayer" in I. R. C. of 1939 § 122(b)(2)(C).[2] The purposes of the loss carry-over section, as revealed by the legislative history, yielded the solution:

> "The requirement of a continuity of business enterprise as applied in this case is in accord with the legislative history of the carry-over and carry back provisions. Those provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year. There is, however, no indication in their legislative history that these provisions were designed to permit the averaging of the pre-merger losses of one business with the post-merger income of some other business which had been operated and taxed separately before the merger. What

[2] "* * * If for any taxable year beginning after December 31, 1947, and before January 1, 1950, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the three succeeding taxable years. * * *"

prise—continuity of stock ownership. Where there is continuity of ownership, there might well be justice in allowing a loss carry-over even though there has been a complete change in the nature of corporate activity. The purposes of the statute are ultimately directed toward granting a legitimate tax advantage to the shareholders behind the corporate entity. See *Newmarket Manufacturing Co.* v. *United States*, 233 F. 2d 493 (1 Cir. 1956), cert. denied 353 U.S. 983 (1957). It may well be that shareholders who sustain a loss and then are wise enough to liquidate an uneconomic enterprise and embark on a different and profitable field of endeavor through the same corporation are equally entitled to offset the earlier losses as those who see an unprofitable corporation through the lean years into the good ones in the same activity. But there was no such continuity of ownership in the present case. The losses were sustained by the group of shareholders who sold their stock to Lehman Bros. at the same time that Lehman Bros. was engaged in selling the corporate assets at a price carefully calculated to yield a profit. It could hardly be contended that the investment bankers bore the ultimate incidence of the three million dollar loss on the sale of the assets that fell in the first instance on Consolidated; in fact, it is agreed that they made a profit of approximately $200,000 on the sale to Ziegler. Further, it is clear that the benefit of the 1954 profits accrued to an almost entirely different group of persons from those who suffered the loss. Former Consolidated shareholders retained at most a 3% ownership of Consolidated-Ketay at that time. Whatever percentage might be necessary to constitute substantial continuity of ownership, it is more than that.

As there was neither continuity of ownership nor continuity of enterprise between the period of loss and the period of gain, we find the "continuity of business enterprise" required by *Libson Shops* to be lacking. No intelligible legislative purpose would be served by permitting

a substantially new group of shareholders engaged in a different enterprise to benefit from the losses sustained by earlier owners in another business. In such a case, the corporate entity is the only link between them. The basic teaching of *Libson Shops* is that this is not enough. Decisions of the other Courts of Appeals in similar fact situations are in accord with this conclusion. See *J. G. Dudley Co.* v. *Commissioner*, 298 F. 2d 750 (4 Cir. 1962); *Commissioner* v. *Virginia Metal Products, Inc.*, 290 F. 2d 675 (3 Cir.), cert. denied 368 U. S. 889 (1961); *Willingham* v. *United States*, 289 F. 2d 283 (5 Cir.), cert. denied 368 U. S. 828 (1961); *Bookwalter* v. *Hutcheus Metal Products, Inc.*, 281 F. 2d 174 (8 Cir. 1960); *Mill Ridge Coal Co.* v. *Patterson*, 264 F. 2d 713 (5 Cir.), cert. denied 361 U. S. 816 (1959).

Petitioner seeks to distinguish these cases in several ways. First, it is argued that they involved "shell" corporations, unlike the present case. But this is to ignore the fact that Consolidated was for all practical purposes a "shell" for a long period of time, at least from the sale of all its operating assets in February, 1951 until the receipt of $250,000 cash from Ziegler Coal & Coke Co. in March, 1952. During this period, it had no significant assets except the unliquidated contract claim on Ziegler and engaged in no business activity. The only actions taken, declaration of liquidating dividends and filing of a statement of intent to liquidate, indicated instead that Consolidated was in the process of complete liquidation. A corporation with no tangible assets engaging in no business activity might fairly be called a "shell".

Next, petitioner states that the only reason for the acquisition of a new enterprise in the above-cited cases was to take advantage of a potential loss carry-over, whereas here there is evidence that Lehman Bros. bought the stock without knowledge of the potential loss carry-over and with the sole objective of selling the stock at a profit. But this

argument fails to recognize that findings under the loss carry-over provisions are independent of findings under I. R. C. of 1939 § 129, which would invalidate a transaction whose principal purpose was evasion or avoidance of taxes. In these cases, and in *Libson Shops* itself, the events were found not to permit a loss carry-over even though there was no Tax Court finding of an intent to evade or avoid taxes. Thus, whatever may be petitioner's view of the transactions at issue, the courts tested them without tax evasion being established. As was said in *Libson Shops*, "the fact that §129(a) is inapplicable does not mean that petitioner is automatically entitled to a carry-over." 353 U. S. at 389. The situation is the same here.

Finally, petitioner argues that the case is distinct because assets were purchased by the corporation rather than contributed by shareholders or acquired through merger. It should be recalled in this connection that a three million dollar group of companies was "purchased" for a down payment of $100,000, without security, by a corporation having no other assets than $250,000 cash and the loss carry-over potential. The shareholders of the companies "purchased" were permitted to acquire a substantial interest in the purchaser and to continue to take part in management. This fact situation could well be considered to be a *de facto* merger—with Consolidated contributing its loss carry-over. But we need not reach this position, for we find no significance in this type of "purchase." The contrary result would destroy the effect of *Libson Shops*, for any corporation with a loss history would be able to negotiate a like purchase, financing the future payments through the tax savings gained by applying the loss carry-over against future income. In effect, though cash might be lacking, the loss carry-over would furnish the purchase price. There is, therefore, no significant distinction between this situation and the group of cases in which other Courts of Appeals have disallowed a loss carry-over.

Petitioner's second argument for reversal of the Tax Court decision is wholly without substance. It is contended that the Commissioner is estopped to assert the deficiency by a prior favorable decision allowing the loss carry-over. But there was no such prior favorable determination by the Commissioner. A Revenue Agent (not the Commissioner), in the course of determining that the liquidating dividends paid by Consolidated would not be taxable as income to the recipients in the event of its continued existence, stated that loss carry-over available for subsequent years to 1952 totaled $3,150,582.26. This report was made in 1952, before any of the assets which produced the new income had been acquired. Thus, the facts of the case could not have been before the Agent. The statement was merely a summary of some mathematical calculations made in a different context and represented no determination whatever that the operating loss would be available to different shareholders to offset the profits of another business. Even if such a determination had been made, it would have been a mistake of law which would work no estoppel. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957).

The decision of the Tax Court is affirmed.

II. JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-eighth day of June one thousand nine hundred and sixty-three.

Present:

HON. STERRY R. WATERMAN,
HON. HENRY J. FRIENDLY,
HON. J. JOSEPH SMITH,
Circuit Judges

NORDEN KETAY CORPORATION (formerly Ketay Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Appeals from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

(SEAL)

A. DANIEL FUSARO, *Clerk*.
By VINCENT A. CARIAN
Chief Deputy Clerk

III. ORDERS OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING PETITIONS FOR REHEARING.

A. Order Denying Petition For Rehearing.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

NORDEN-KETAY CORPORATION (formerly Ketay Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR REHEARING

DON V. HARRIS, JR. and COVINGTON & BURLING, Washington, D. C., for petitioner.

Petition denied.

S. R. W.
J. J. S.
U.S.C.J.J.

30 July 1963

B. Order Denying Petition For Rehearing In Banc.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

NORDEN-KETAY CORPORATION (formerly Ketay Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR REHEARING IN BANC

DON V. HARRIS, JR. and COVINGTON & BURLING, Washington, D. C., for petitioner.

No active circuit judge having requested that the case be reheard in banc, the petition is denied.

J. EDWARD LUMBARD
Chief Judge

30 July 1963

IV. MEMORANDUM FINDINGS OF FACT AND OPINION OF THE TAX COURT OF THE UNITED STATES.

A. Headnote.

Petitioner corporation which had engaged for many years in a coal-mining business, sold all of its operating assets in 1951, and as a result thereof sustained a net operating loss in said year. Thereafter, said corporation acquired the stock of three other corporations which manufactured precision electronic components, dissolved said corporations, took over the assets and going businesses thereof, and continued to operate an electronics business throughout the taxable year. *Held*, that there was no "continuity of business enterprise" between the former mining business and the subsequent electronics business; and, accordingly, that petitioner is not entitled to carry over and deduct the 1951 net operating loss against its 1954 income realized in its new and different business of manufacturing electronic components. *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, and *Hoaglin's*, 38 T.C. — (Aug. 30, 1962), followed.

B. Memorandum Findings of Fact and Opinion.

PIERCE, *Judge*:

The respondent determined a deficiency in petitioner's income tax for the calendar year 1954 in the amount of $30,033.33.

The basic question for decision is whether the petitioner, which had experienced substantial changes in the character of its business, its name, its place of operation, its management, and its capital structure—as the result of the discontinuance of its former business of mining coal, and its taking over a new type of business of manufacturing electronic components that had theretofore been operated by three other corporations—may under section 172 of the 1954 Code and section 122 of the 1939 Code, carry over and deduct from its 1954 income from such electronics business, a net operating loss sustained in 1951 in the former business of mining and selling coal.

Another issue relating to an adjustment which increased petitioner's net sales for 1954, was abandoned by petitioner at the trial by amending its petition so as to delete all references therein to said issue.

Findings of Fact

General Facts

Some of the facts were stipulated. The stipulation of facts, together with the exhibits identified therein, is incorporated herein by reference.

The petitioner is a dissolved Illinois corporation which, during the taxable calendar year 1954 here involved, had its principal place of business in New York City. It filed a corporation income tax return for said year with the district director of internal revenue for the Lower Manhattan District of New York.

The notice of deficiency herein was issued on May 12, 1959. The petitioner was thereafter dissolved on July 1, 1959. The petition to this Court was subsequently filed on August 7, 1959. Under the provisions of section 94 of the Business Corporation Act of the State of Illinois, petitioner was authorized to bring and maintain this action in its own name, despite its dissolution. No dispute is here involved regarding petitioner's right to conduct the present proceeding.

Petitioner was incorporated under the laws of the State of Illinois on July 20, 1886, under the name of "The Consolidated Coal Company of St. Louis." Its name was changed on February 20, 1935, to "The Consolidated Coal Company."[1] Thereafter, in connection with events and

[1] Hereinafter, when reference is made to the corporation in connection with events and transactions occurring when it bore the name of "The Consolidated Coal Company," said corporation will be referred to as "Consolidated."

transactions presently to be described, petitioner underwent other changes of name as follows: On April 15, 1953, its name was changed to "Ketay Manufacturing Corp."; on September 10, 1954, its name was changed to "Ketay Instrument Corporation"; and on February 11, 1955, its name was changed to "Norden-Ketay Corporation," which is the name it continued to bear until its above-mentioned dissolution, and under which it filed its petition herein.

Facts re Consolidated at and prior to sale of coal business assets in February 1951

The business of Consolidated from the time of its incorporation in 1886 until February 1951, was that of mining and selling bituminous coal. Its principal office while so engaged was in St. Louis, Missouri; but its extensive mining properties were located in the coal fields of southern Illinois. It also owned all of the outstanding capital stock of four subsidiary companies.[2] During the years 1949 and 1950, respectively, its net sales were $7,050,114.43 and $7,146,465.98, and its net incomes before Federal income taxes were $246,930.79 and $278,290.15. As of December 31, 1949 and 1950, its total assets were $8,952,848.95 and $9,086,818.39, respectively; and at said dates the amounts of its earned surplus were $7,174,985.05 and $3,243,275.20, respectively.

In the Fall of 1950, an attorney representing a decedent's estate which owned the largest single block of Consolidated's stock, approached the New York investment banking firm of Lehman Brothers, and suggested the possibility

[2] The record contains no definite evidence as to the types of business carried on by these subsidiaries. Perhaps some indications in this regard may be gleaned from the names of the subsidiaries: Consol Power Company, St. Louis, Missouri; Jefferson Southwestern Railroad Company, St. Louis, Missouri; Federal Coal Corporation, Chicago, Illinois; and Jefferson Oil and Gas Corporation, St. Louis, Missouri.

of said firm acquiring a controlling interest in said stock. Lehman Brothers was receptive to the suggestion; and thereupon it made arrangements with the Bankers Trust Company of New York to solicit (on behalf of Lehman Brothers, as undisclosed principal) options to purchase shares from the larger shareholders of Consolidated. After options covering approximately 94 percent of the Consolidated stock had thus been secured, Lehman Brothers began to search for a buyer of such stock in the event that it should decide to exercise such options. Following several unsuccessful attempts, Lehman Brothers did locate a potential purchaser, which was Zeigler Coal & Coke Company (hereinafter called Zeigler), an Illinois corporation engaged in operating coal mines in Illinois.

Lehman Brothers' desire was to sell the *stock* of Consolidated; and in its preliminary negotiations with Zeigler, an informal agreement was reached to sell the shares which it had under option at a price which would yield it a profit of $200,000. Later however, Zeigler indicated that it would be interested only in buying Consolidated's assets, and not the stock. Lehman Brothers thereupon advised that it would be agreeable to such a revised transaction, provided that it could realize the contemplated $200,000 profit, and provided also that it would not have to bear any expense that it would not bear if it sold the stock.

Lehman Brothers thereupon instructed its agent, the Bankers Trust Company, to exercise the options to purchase shares of Consolidated stock held on behalf of Lehman Brothers; and by February 28, 1951, the Trust Company had purchased 47,447 shares (or 94.7 percent of all the shares outstanding) on behalf of Lehman Brothers.

On February 26, 1951, Consolidated and Zeigler entered into an agreement of sale; and 2 days later, on February 28, 1951, Consolidated conveyed to Zeigler all of its assets except cash and United States Treasury obligations, and received in partial payment from Zeigler the sum of $2,900,

000 in cash. In addition to the cash thus paid by Zeigler, the corporation also agreed to pay over to Consolidated at later dates, 50 percent of the excess over $800,000 which Zeigler might receive upon its sale of certain so-called "disposable properties,"[1] received in the purchase from Consolidated.

Immediately upon receipt of the cash payment of $3,000,000 above mentioned, the directors of Consolidated declared and there was paid a "partial liquidating dividend" of $76.50 per share; and in May of 1951, the directors declared another "partial liquidating distribution" of $1.50 per share, which amount also was paid in the latter month. Lehman Brothers utilized said liquidating dividend and distribution (totalling $78 per share) which it thus received, for paying bank loans incurred by it in purchasing the shares of Consolidated, and also for paying certain brokerage commissions which it incurred in connection with said purchase.

In February 1954, a statement of intent to dissolve Consolidated was filed on behalf of that corporation with the Secretary of State of the State of Illinois. At no time after the above-described sale of operating assets to Zeigler did Consolidated ever conduct, manage, or operate a business of mining or selling coal.

Consolidated sustained a loss on the above-mentioned and above-described sale of its operating assets related to

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[1] The "disposable properties" which were assets of Consolidated that Zeigler did not plan or desire to retain, included all of the tangible assets of Consolidated which were situated in four Illinois counties, and also the capital stock of three of the four of Consolidated's subsidiary corporations. The $3,000,000 cash payment was sufficient only, when paid out to Consolidated's shareholders, to cover the out-of-pocket costs of Lehman Brothers. That firm had planned that its share of the proceeds from the sale of the "disposable properties" would constitute its profit on the purchase and sale of Consolidated stock.

coal mining in the amount of $3,509,043.55; and said corporation thereby sustained a net operating loss in said year 1951 in the amount of $3,466,387.52.

Facts re Consolidated following sale of coal business assets.

In the Spring of 1951, Lehman Brothers disposed of three blocks of its shares of Consolidated stock, as follows:

1. March 14, 1951, 4,447 shares were transferred to Emmanuel Becker, the attorney who had suggested to Lehman Brothers the acquisition of the Consolidated stock. Said shares were transferred at Consolidated's unrecovered cost of $1.50 per share, pursuant to an agreement between the attorney and Lehman Brothers, that the latter would give Becker 10 percent of any profit that Lehman Brothers might realize from the Consolidated stock transactions. The shares so transferred to Becker were intended to assure to Becker 10 percent of whatever profit Lehman Brothers might realize in final liquidation of Consolidated.

2. March 21, 1951, 2,372 shares were transferred to Paul Weir, a mining engineer and geologist, who had assisted Lehman Brothers in its search for a buyer for the Consolidated stock. These shares were likewise transferred at a price of $1.50 per share, pursuant to an agreement to share with him 5 percent of any profit which Lehman Brothers might realize on the Consolidated deal. These shares were subsequently reacquired by Consolidated in March or April, 1953.

3. April, 1951, 3,500 shares were transferred to Joseph H. McConnell, then president of the National Broadcasting Company, at $1.50 per share. The record herein does not reveal the reason for said transfer of shares to McConnell, other than it was made for reasons unrelated to the other transactions relevant to the present proceeding.

In June 1951, Consolidated's capital structure was altered, by reducing the par value of its stock from $100 per share to $1 per share, thus reducing its stated capital from $5,000,000 to $50,000.

During the interval from the sale of its assets to Zeigler on February 28, 1951, to the end of the year 1951, Consolidated was inactive. Zeigler hired two former employees of Consolidated to attend to collecting the accounts receivable, and to paying the accounts payable which Zeigler had purchased and assumed. Also, two of the directors of Consolidated had some correspondence with the president of Zeigler, wherein they urged that Zeigler proceed with greater speed to sell the above-mentioned "disposable properties," in the proceeds of which Consolidated was to share after the amount thereof had reached $800,000. By the end of the year 1951, Zeigler had realized approximately $790,000 from the sale of about 55 percent of such disposable properties.

Following the end of the year 1951, Zeigler made an offer to Consolidated to purchase the latter's interest in the disposable properties for $250,000. Consolidated accepted the offer, and on March 26, 1952, it entered into a "First Supplemental Agreement" with Zeigler, the here material provisions of which were, in substance, as follows:

> (1) Zeigler agreed to pay, and Consolidated agreed to accept, $250,000 in full settlement of the balance of the purchase price under the agreement between the two companies of February 26, 1951.
>
> (2) Consolidated agreed that upon receipt of the aforesaid sum of $250,000 it would "immediately take steps to dissolve" and that it would "complete its dissolution as quickly as may be reasonably possible."

The $250,000 mentioned in the foregoing agreement was paid by Zeigler to Consolidated immediately following execution of the same.

The officers of Consolidated, upon receipt of the above-mentioned $250,000, began to consider the possibility of not proceeding further with the dissolution of the corporation, but rather of having said corporation enter into some new type of business. Negotiations were thereupon undertaken by Consolidated with Zeigler to have that corporation waive the requirement that Consolidated be dissolved. About a year later, Zeigler and Consolidated entered into a "Second Supplemental Agreement" on April 2, 1953, wherein it was provided that Zeigler would waive the requirements that Consolidated be dissolved.

Five days later, on April 7, 1953, the stockholders of Consolidated adopted a resolution that the voluntary dissolution proceedings previously begun, should be revoked; and 2 days thereafter, on April 9, Consolidated filed with the Secretary of State of the State of Illinois a "Statement of Revocation of Dissolution Proceedings." Previously thereto, on March 30, 1953, said officials had issued a certificate that as of said date Consolidated was still in good standing as a domestic corporation of the State of Illinois.

During the interval between the above-mentioned March 1952 "First Supplemental Agreement" between Zeigler and Consolidated and the just-mentioned revocation of the dissolution proceedings, the officers of Consolidated conducted a search for some business which the corporation might buy. In this connection, sometime in the Fall of 1952, the officers of Consolidated began negotiations with an individual named Benjamin Gross, who represented the stockholders of a 3-member group of corporations, Ketay Manufacturing Corp., Kinetix Instrument Co., and Ketay Research & Development Co. (said three corporations are hereinafter referred to collectively as the "Ketay companies"), with a view to purchasing all the capital stocks of said three Ketay companies. The Ketay companies were at that time engaged in the business of developing, manufacturing, and selling precision electronic components.

These negotiations culminated in an agreement dated April 6, 1953, whereby Consolidated agreed to purchase all the outstanding shares of each of the three Ketay companies for a total consideration of $2,725,000, payable $100,000 in cash at the closing date, with the balance payable in installments on or before March 1, 1958. Said agreement was thereafter amended in one respect, viz., to increase the purchase price by $25,000. The purpose of buying said stock was to obtain the assets of the Ketay companies.

Concurrently with the execution of the stock purchase agreement of April 6, 1953, and as an integral part of the Ketay stock purchase transaction, Consolidated and the Ketay stockholders entered into a second agreement whereunder Consolidated agreed that it would increase the number of its authorized shares of capital stock from 50,000 to 75,000 and that it would issue and sell to the Ketay stockholders, warrants entitling them to purchase the additional 25,000 shares of Consolidated common stock at a price of $4.95 per share. The selling price of the warrants themselves was fixed at 5c for each share of stock covered thereby.

On April 9, 1953, Consolidated's articles of incorporation were amended in the following respects:

(1) Its corporate purposes were expanded to include the purposes of dealing in personal property and of engaging in manufacturing and mercantile enterprises;

(2) Its authorized shares of $1 per share common capital stock were increased from 50,000 to 75,000; and

(3) The preemptive right of shareholders to subscribe for or acquire additional shares was abrogated.

Thereafter, on April 15, 1953, closing took place under the aforesaid agreements between Consolidated and the Ketay stockholders; and Consolidated thereupon acquired all of the outstanding capital stock of each of the three

Ketay corporations. On the same day, immediately following Consolidated's purchase of the Ketay stocks, each of said Ketay companies filed with the Secretary of State of the State of New York its certificate of dissolution. Still on the same day, Consolidated changed its name to "Ketay Manufacturing Corp."[4] On the following day, April 16, the New York Secretary of State dissolved said three corporations. Consolidated-Ketay thereupon took over the going businesses, and became the owner of all of the assets and properties of the former Ketay companies; and it also assumed all of the liabilities of said companies. Consolidated-Ketay moved its principal office to New York City, and continuously thereafter engaged, until its own dissolution on July 1, 1959 (as hereinabove found as a fact), solely in the same business formerly carried on by the former Ketay companies, i.e., the development, manufacture and sale of precision electronic components.

Also on April 17, 1953, the stockholders of Consolidated-Ketay elected eight directors for the corporation, four of whom had been stockholders in the former Ketay companies.[5] Following this stockholders' meeting, the directors met and elected new officers for the corporation, including in various positions all those individuals who had been stockholders in the former Ketay companies. Said officers continued to serve throughout the taxable year 1954 here involved.

[4] As hereinabove found, the corporate name was subsequently changed on September 10, 1954, to "Ketay Instrument Corporation"; and its name was again changed on February 11, 1955, to "Norden-Ketay Corporation." Said corporation will be hereinafter referred to for convenience as "Consolidated-Ketay."

[5] At least three and possibly all four of the other directors were associated with Lehman Brothers, and they had been elected in February 1951, shortly prior to the sale of assets by Consolidated to Zeigler. None of the eight directors of Consolidated-Ketay had been associated with Consolidated during the years when it operated the coal-mining business.

Subsequently, on August 15, 1953, all of the above-described stock warrants which had been issued to the former Ketay stockholders, were exercised by said individuals or by other parties to whom such individuals had transferred or assigned the same.

The capital structure of Consolidated-Ketay was subsequently changed in the following respects:

(1) On November 2, 1953, the authorized common capital stock was changed and increased from 75,000 shares, having a par value of $1 per share, to 850,000 shares having a par value of 10¢ per share; and said 75,000 shares of $1 par-value stock were split 10 for 1, and reclassified and changed into 750,000 shares having a par value of 10¢ per share.

(2) On June 22, 1954, the authorized common capital stock was further increased from 850,000 shares, par value of 10¢ per share, to 2,000,000 shares, par value of 10¢ per share. On September 29, 1954, 300,000 of the newly authorized shares were sold to underwriters for subsequent sale to the members of the public.

Consolidated-Ketay, on the Federal income tax return which it filed for the taxable calendar year 1954 here involved, reported taxable income from its electronics business of $1,007,623.38, before net operating loss deduction. On this same return it carried over from the year 1951 a net operating loss of $2,304,125.58 which had resulted principally from the sale of the assets of the coal-mining business; and it claimed such operating loss as a deduction—thereby reporting loss on the return for 1954 in the amount of $1,296,502.20.

The respondent, in his notice of deficiency herein, disallowed said claimed net operating loss deduction.

OPINION

The basic issue in this case is, as above stated, whether the petitioner is entitled to carry over and deduct against its 1954 income from a business of manufacturing electronic components, a net operating loss sustained by the same corporate entity in 1951 when it, as a coal-mining company, disposed of the operating assets of the coal-mining business which it had theretofore conducted.

We have, only recently, considered a similar question in the case of *Hunler's*, 38 T.C. — (Aug. 30, 1962). We there held, applying the "continuity of business enterprise" principle enunciated by the Supreme Court in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, that a taxpayer-corporation which had experienced substantial changes in its stock ownership and in the character of its business, could not carry over and deduct from its income of years following such changes, net operating losses sustained in its former business prior to the changes. There are, of course, factual distinctions between the *Hunler's* case and the instant case. For example, Huyler's went from a business of manufacturing candy and operating a chain of restaurants to a business of manufacturing aluminum products; while here, the petitioner's original business was that of mining and selling coal, and its subsequent business (as it existed in the taxable year for which the deduction involved was claimed) was that of manufacturing precision electronic components. Also, in *Hunler's*, there was a Chapter X bankruptcy reorganization, while here there was no reorganization. But these are mere distinctions, without any real underlying differences of legal principle which would call for a different result here. In the instant case, in the interval between the year (1951) when the net operating loss here involved was sustained and the year (1954) in which petitioner has sought to carry over and deduct said loss, there were radical changes in the business enterprise involved—including changes in the capital structure of the

business, in the location of the business, in the management of the business, in the stock ownership of the business, in the type of the business and its products, and even in the name of the business. We are impelled to conclude in such circumstances, that the 1954 income was not produced from substantially the same business as that which produced the 1951 loss; and hence, that there was no "continuity of business enterprise," as that phrase is used in the *Libson Shops* case and as it has been construed and applied by this and other courts in: *Huyler's, supra; K. G. Dudley, Inc.*, 36 T.C. 1122, affd. (C.A. 4) 298 F. 2d 750; *Mill Ridge Coal Co. v. Patterson*, (C.A. 5) 264 F. 2d 713, certiorari denied 361 U.S. 816; and *Willingham v. United States*, (C.A. 5) 298 F. 2d 283.

Since the conclusion which we have above set forth is dispositive of this case, we find it unnecessary to discuss the other contentions which petitioner presented.

We hold that deduction by petitioner of the net operating loss here involved is not allowable. We sustain the determination of the Commissioner in this regard.

Decision will be entered for the respondent.

V. ORDER AND DECISION OF THE TAX COURT OF THE UNITED STATES.

"DECISION

"Pursuant to the Determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion filed October 23, 1962, it is

"ORDERED AND DECIDED: That there is a deficiency in income tax for the calendar year 1954 in the amount of $630,033.33.

"(Signed) ALLEN H. PIERCE
Judge"

"ENTER:

"ENTERED Oct. 24, 1962"

VI. STATUTES INVOLVED.

A. Allowance of Petitioner's Net Operating Loss.

1. Application of the Internal Revenue Codes of 1939 and 1954.

It is not contested that Petitioner had a net operating loss for the calendar year 1951.

To the extent that said loss was not absorbed against Petitioner's profits for 1950 and 1953, as set forth in the stipulated figures, that loss is allowed to Petitioner as a deduction for the calendar year 1954 under Section 172(a) of the Internal Revenue Code of 1954.

Section 172 of the Internal Revenue Code of 1954 is a part of Subtitle A, Chapter 1, Subchapter B, Part VI, of said Code. Under Section 7851(a)(1)(A) of said Code, 26 U.S.C. § 7851(a)(1)(A) (1958 ed.), 68A Stat. 919, Aug. 16, 1954, said Section 172 is applicable with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. The calendar year 1954 is such a year. The allowance of the loss on the 1954 return is, therefore, pursuant to Section 172 of the 1954 Code.

The computation of the amount of the loss which arose in 1951, and the computations of the amounts of said loss absorbed by carryback to 1950 and carryover to 1953, are made under the law applicable to each said year, Section 172(e) of the Internal Revenue Code of 1954. These figures are stipulated.

The determination of the years to which a loss for the calendar year 1951 may be carried is made under the applicable provisions of the Internal Revenue Code of 1939. Section 172(g)(1) of the Internal Revenue Code of 1954. Petitioner's 1951 loss which may be carried forward to 1954 is stipulated.

Petitioner had an excess of deductions over gross income for 1951, in the stipulated amount, which was a net operat-

ing loss under Section 122(a) of the Internal Revenue Code of 1939, 26 U.S.C. § 122(a) (1952 ed.), 53 Stat. 867, June 29, 1939, 56 Stat. 807, October 21, 1942. Such loss was first a carryback to 1950 under Section 122(b)(1)(B) of the Internal Revenue Code of 1939; 26 U.S.C. § 122(b)(1)(B) (1952 ed.), 53 Stat. 867, June 29, 1939, 56 Stat. 847, 848, October 21, 1942, 64 Stat. 938, September 23, 1950. The unused portion of said loss was thereafter a carryover for each of the five taxable years succeeding 1951, under Section 122(b)(2)(B) of the Internal Revenue Code of 1939, 26 U.S.C. § 122(b)(2)(B) (1952 ed.), 53 Stat. 867, June 29, 1939, 56 Stat. 847, 848, October 21, 1942, 64 Stat. 938, September 23, 1950. The required "exceptions, additions, and limitations" have been taken into account in the stipulated figures.

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2. *Text of Section 172 of the Internal Revenue Code of 1954, as in Effect for the Calendar year 1954, Including Retroactive Amendments by Pub. L. 85-866.*

SEC. 172. NET OPERATING LOSS DEDUCTION.

(a) Deduction Allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net Operating Loss Carrybacks and Carryovers.—

(1) Years to Which Loss May Be Carried.—A net operating loss for any taxable year ending after December 31, 1953, shall be—

(A) a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and

(B) a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(2) Amount of Carrybacks and Carryovers.—Except as provided in subsection (f), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the 7 taxable years to which (by reason of subparagraphs (A) and (B) of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other 6 taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter,

and the taxable income so computed shall not be considered to be less than zero.

(c) Net Operating Loss Defined.—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) Modifications.—The modifications referred to in this section are as follows:

(1) Net Operating Loss Deductions.—No net operating loss deduction shall be allowed.

(2) Capital Gains and Losses of Taxpayers Other Than Corporations.—In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) Deductions for Personal Exemptions.—No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness Deductions of Taxpayers Other Than Corporations.—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business,

shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account; and

(C) any deduction allowable under section 165 (g)(3) (relating to casualty losses) shall not be taken into account.

(5) Special Deductions for Corporations.—No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) Computations of Deductions for Dividends Received, etc.—The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a)(1)(B) of such section.

(e) Law Applicable to Computations.—In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954.

(f) Taxable Years Beginning in 1953 and Ending in 1954.—In the case of a taxable year beginning in 1953 and ending in 1954—

(1) In lieu of the amount specified in subsection (c), the net operating loss for such year shall be the sum of—

(A) that portion of the net operating loss for such year computed without regard to this subsection

which the number of days in the loss year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss for such year computed under section 122 of the Internal Revenue Code of 1939 as if this section had not been enacted which the number of days in the loss year before January 1, 1954, bears to the total number of days in such year.

(2) The amount of any net operating loss for such year which shall be carried to the second preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1953, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the second taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the second preceding taxable year.

(3) The net operating loss deduction for such year shall be, in lieu of the amount specified in section 122(c) of the Internal Revenue Code of 1939, the sum of—

(A) that portion of the net operating loss deduction for such year, computed as if subsection (a) of this section were applicable to the taxable year, which the number of days in such year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss deduction for such year, computed under section 122(c) of the Internal Revenue Code of 1939 as if this paragraph had not been enacted, which the number of days in such year before January 1, 1954, bears to the total number of days in such year.

(4) For purposes of the second sentence of subsection (b)(2), the taxable income for such year shall be the sum of—

(A) that portion of the net income for such year, computed without regard to this paragraph, which the number of days in such year before January 1, 1954, bears to the total number of days in such year, and

(B) that portion of the net income for such year, computed—

(i) without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code,

which the number of days in such year after December 31, 1953, bears to the total number of days in such year.

(g) Special Transitional Rules.—

(1) Losses for Taxable Years Ending Before January 1, 1954.—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.

(2) Losses for Taxable Years Ending After December 31, 1953.—For purposes of section 122 of the Internal Revenue Code of 1939—

(A) the determination of the taxable years ending before January 1, 1954, to which a net operating loss

for any taxable year ending after December 31, 1953, may be carried shall be made under subsection (b) (1) (A) of this section; and

(B) in determining the amount of the carryback to the first taxable year preceding the first taxable year ending after December 31, 1953, the portion of the net operating loss carried to such year shall be such net operating loss reduced by—

(i) the net income for the second preceding taxable year computed as if the second sentence of section 122(b)(2)(B) of the Internal Revenue Code of 1939 applied, or

(ii) if smaller, the portion of the net operating loss which by reason of subsection (f) of this section is carried to the second preceding taxable year.

(3) Taxable Years Beginning After December 31, 1953, and Ending Before August 17, 1954.—In the case of a taxable year which begins after December 31, 1953, and ends before August 17, 1954—

(A) the net operating loss deduction for such year shall be computed as if subsection (a) of this section applied to such taxable year; and

(B) for purposes of the second sentence of subsection (b)(2), the taxable income for such taxable year shall be the net income for such taxable year, computed—

(i) without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code.

(4) Excess Profits Tax Not Affected.—For purposes of subchapter D of chapter 1 of the Internal Revenue Code of 1939, excess profits net income shall be computed as if this section had not been enacted and as if section 122 of such Code continued to apply to taxable years to which this subtitle applies.

(h) Cross References.—

(1) For treatment of net operating loss carryovers in certain corporate acquisitions, see section 381.

(2) For special limitation on net operating loss carryovers in case of a corporate change of ownership, see section 382.

B. Section 129 of the Internal Revenue Code of 1939 and Section 269 of the Internal Revenue Code of 1954.

1. *Effective Dates.*

Section 129 is applicable to acquisitions made on or after October 8, 1940, and to taxable years beginning after December 31, 1943, but was repealed as to taxable years beginning after December 31, 1953 and ending after August 16, 1954. Section 269 applies to acquisitions made on or after October 8, 1940, and to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

2. *Text of Section 129 of the Internal Revenue Code of 1939.*

SEC. 129. ACQUISITIONS MADE TO EVADE OR AVOID INCOME OR EXCESS PROFITS TAX.

(a) Disallowance of deduction, credit, or allowance. If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation

or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For the purposes of clauses (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote or at least 50 per centum of the total value of shares of all classes of stock of the corporation.

(b) Power of Commissioner to allow deduction, etc., in part. In any case to which subsection (a) is applicable the Commissioner is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated; but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

3. Text of Section 269 of the Internal Revenue Code of 1954.

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) Power of Secretary or His Delegate To Allow Deduction, etc., In Part.—In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

(c) Presumption in Case of Disproportionate Purchase Price.—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and

(2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,

shall be prima facie evidence of the principal purpose of evasion or avoidance of Federal income tax. This subsection shall apply only with respect to acquisitions after March 1, 1954.

C. Section 382 of the Internal Revenue Code of 1954.

1. *Effective Date:*

Subsection 382(a) generally applies to taxable years beginning after December 31, 1953, and ending after August 16, 1954, but Subsection 382(a) is only applicable with re-

spect to changes in stock ownership occurring on or after June 22, 1954."

2. *Text of Subsection 382(a) of the Internal Revenue Code of 1954:*

SEC. 382. SPECIAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS.

(a) Purchase of a Corporation and Change in Its Trade or Business.—

(1) In General.—If, at the end of a taxable year of a corporation—

(A) any one or more of those persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to—

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, and

(C) such corporation has not continued to carry on a trade or business substantially the same as

that conducted before any change in the percentage ownership of the fair market value of such stock,

the net operating loss carryovers, if any, from prior taxable years of such corporation to such taxable year and subsequent taxable years shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years.

(2) Description of Person or Persons.—The person or persons referred to in paragraph (1) shall be the 10 persons (or such lesser number as there are persons owning the outstanding stock at the end of such taxable year) who own the greatest percentage of the fair market value of such stock at the end of such taxable year; except that, if any other person owns the same percentage of such stock at such time as is owned by one of the 10 persons, such person shall also be included. If any of the persons are so related that such stock owned by one is attributed to the other under the rules specified in paragraph (3), such persons shall be considered as only one person solely for the purpose of selecting the 10 persons (more or less) who own the greatest percentage of the fair market value of such outstanding stock.

(3) Attribution of Ownership.—Section 318 (relating to constructive ownership of stock) shall apply in determining the ownership of stock, except that section 318(a)(2)(C) shall be applied without regard to the 50 percent limitation contained therein.

(4) Definition of Purchase.—For purposes of this subsection, the term "purchase" means the acquisition of stock, the basis of which is determined solely by reference to its cost to the holder thereof, in a transaction from a person or persons other than the person or persons the ownership of whose stock would be attributed to the holder by application of paragraph (3).

VII. PERTINENT REVENUE RULINGS.

A. Text of Revenue Ruling 58-603, 1958-2 Cum. Bull. 147

In Libson Shops, Inc., v. *Koehler*, 353 U. S. 382, Ct. D. 1809, C. B. 1957-2, 891, the Supreme Court of the United States announced the principle that, under the Internal Revenue Code of 1939, a surviving corporation in a merger may not carry over and deduct pre-merger net operating losses of one business against post-merger income of another business which was operated and taxed separately before the merger. The principle announced in that case will not be relied upon by the Internal Revenue Service under the Internal Revenue Code of 1954 as to a merger or any other transaction described in section 381(a) of the 1954 Code. However, see sections 382(b) and 269 of the 1954 Code for the possible disallowance of net operating loss carryovers in such transactions, and see the Income Tax Regulations under section 368 of the 1954 Code for the Requirements of a reorganization.

B. Text of Revenue Ruling 59-395, 1959-2 Cum. Bull. 475

In view of the decision of the Supreme Court of the United States in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, Ct. D. 1809, C. B. 1957-2, 891, consideration has been given the extent to which net operating losses or unused excess profits credits may be carried back or carried over across the line of the corporate fusion after a statutory merger or consolidation the tax treatment of which is determined under the provisions of the Internal Revenue Code of 1939.

In the *Libson Shops* case, *supra*, there were involved 17 corporations, all chartered in 1946 and all owned directly or indirectly by the same individuals in the same proportions. Of the 17 corporations one was a management corporation and the remainder were operating corporations. After incorporation in 1946, each of the operating corporations was conducted separately and filed separate Federal

income tax returns. In 1949, the operating corporations were merged under state law into the management corporation. The name of the former management corporation was then changed; the amount and pay value of its stock were revised; new shares of capital stock were issued pro rata in exchange for the capital stock of the operating corporations; and the businesses of the management and the operating corporations were merged into a single enterprise which filed a single Federal income tax return.

In the taxable year prior to the merger, three of the operating corporations sustained net operating losses and in the year following the merger each of the units formerly operated by those corporations sustained a net operating loss. In its Federal income tax return for the first year following the merger, the resultant corporation claimed the premerger net operating losses of the units in question as a deduction under sections 23(s) and 122 of the Internal Revenue Code of 1939. Upon examination of the return the Commissioner of Internal Revenue disallowed such claimed deduction. The disallowance was sustained by the United States District Court for the Eastern District of Missouri, affirmed by the Court of Appeals for the Eighth Circuit, and finally by the Supreme Court of the United States.

In its decision in the *Libson Shops* case, *supra*, the Supreme Court took the position that the issue involved centered on the meaning of the phrase "the taxpayer" as used in the statute; that the contentions of the parties required a decision on whether the corporation resulting from the merger involved was "the taxpayer" having the premerger losses; that, for purposes of the net operating loss carryover privilege, the resultant corporation involved the same "taxpayer" as the corporation which prior to the merger sustained the losses only as there was continuity, in the resultant corporation, of substantially the same business enterprise which prior to the merger sustained the

loss; and that, even where there was such a continuity of business enterprise in the resultant corporation, the latter was the same taxpayer as the loss corporation only to the extent that the loss carried over from a premerger year of such loss corporation offset that part of the income of the resultant corporation which was derived from the operation of substantially the same business enterprise which prior to the merger sustained the loss.

The Court observed further that the stated requirement of continuity of business enterprise is in accord with the legislative history of the carry-over and carryback provisions of the 1939 Code; that the availability of the carry-over privilege depends upon the proper interpretation being given to the net operating loss provisions of the Code; that those provisions were enacted to ameliorate the unduly drastic consequences of taxing income on an annual basis and were designed to permit a taxpayer to set off lean years against lush ones and to strike something like an average taxable income computed over a period longer than one year; that there is no indication in the legislative history that the provisions were designed to permit the averaging of the premerger losses of one business with the postmerger income of some other business operated and taxed separately before the merger; that nothing found in such provisions suggested that they should be so construed as to give a "windfall" to a taxpayer who happened to have merged with other corporations; that the purpose of the provisions is not to give a merged taxpayer an advantage over others who have not merged; and that what history there is suggests that Congress primarily was concerned with the fluctuating income of a single business.

The Court noted that the distinctions indicated had already been recognized in the decisions of the courts; that in *Stanton Brewery, Inc. v. Commissioner*, 176 Fed. (2d) 573, in which a carry-over of an unused excess profits credit across the line of a statutory merger was allowed, the

merging corporations carried on essentially a continuing enterprise; that in *Newmarket Manufacturing Company* v. *United States*, 233 Fed. (2d) 493, certiorari denied in 353 U.S. 983, in which a carry-back of a net operating loss across the line of a statutory merger was permitted, a single business was involved; and that in *Koppers Company* v. *United States*, 134 Fed. Supp. 290, certiorari denied, 353 U.S. 983, in which a carry-back of an unused excess profits credit across the line of a statutory merger was allowed, the resultant corporation conducted essentially the same taxable enterprise as was previously carried on since the merged group had previously filed consolidated returns.

Commenting that the difference involved was not merely a "matter of form" the Court observed that, in the *Libson Shops* case, had there been no merger, the three businesses which, prior to the merger, sustained losses would have had no opportunity to carry over such losses since in the succeeding year they had no income; that, had the resultant corporation been permitted to carry over such losses, the 16 businesses included in the resultant corporation would have acquired by merger an opportunity to receive the benefit of a carry-over to which they would not otherwise have been entitled; and that the fact that no question of tax evasion or avoidance, within the purview of section 129 of the 1939 Code, was involved did not mean that following a merger the resultant corporation was automatically entitled to a carry-over of a premerger loss of a constituent.

Since, therefore, in the *Libson Shops* case, the income of the resultant corporation against which the premerger losses were sought to be offset was not produced by substantially the same businesses which produced the losses, the Court concluded that the resultant corporation was not entitled to a carry-over of such losses across the line of the merger.

While on the basis of the particular facts before it in the *Libson* case a carry-over of a net operating loss was there denied, it is the opinion of the Internal Revenue Service that, in view of the principles enunciated and the decisions cited by the Court in that case, a different result would be warranted under the 1939 Code where a carry-over across the line of a statutory merger would result in application of either the premerger losses or unused excess profits credits of an absorbed constituent corporation to offset income derived by the resultant corporation from the same business by which the loss was sustained or the credit acquired. For the same reasons, carry-backs of net operating losses and unused excess profits credits of the resultant corporation attributable to absorbed constituent corporations would appear to be properly allowable, to the extent that they offset premerger income of such constituent corporations, in determining the tax liability to which the resultant corporation has succeeded. These conclusions would seem also to be applicable with respect to consolidations. See *Helvering* v. *Metropolitan Edison Company*, 306 U.S. 522, Ct. D. 1392, C.B. 1939-1 (Part 1), 229, in which, and in cases referred to therein, carry-overs of tax rights across the line of statutory corporate fusions were allowed without apparent regard to whether such statutory fusions were mergers or consolidations.

From the comment of the Court in the *Libson Shops* case, it would appear also that where, following a year in which a group of corporations has properly filed a consolidated return, such group of corporations undergoes a statutory merger or consolidation, and thereafter the resultant corporation conducts the same businesses previously operated by the constituents, the constituent corporations which prior to the merger or consolidations filed a consolidated return are to be regarded as representing collectively, after the merger or consolidation, the same taxable enterprise as before that event.

Accordingly, absent any evasion or avoidance of tax within the purview of section 129 or other provisions of the 1939 Code, with respect to statutory mergers and consolidations the tax treatment of which is determined under such Code, it is held that (1) following a statutory merger or consolidation, the premerger or preconsolidation net operating losses and unused excess profits credits of an absorbed constituent corporation may be carried over to the resultant corporation to the extent that such losses and unused excess profits credits offset income of the resultant corporation attributable to assets acquired by it from the absorbed constituent and used in continuing the prefusion business of such absorbed constituent; (2) the portion of the net operating losses and unused excess profits credits attributable to the assets acquired by the resultant corporation from an absorbed constituent and used in continuing the prefusion business of such absorbed constituent may be carried back, to the extent that they offset the prefusion income of the absorbed constituent, in determining the tax liability to which the resultant corporation has succeeded; and (3) where, following a year in which a group of corporations properly filed a consolidated return, such group undergoes a statutory merger or consolidation and thereafter the resultant corporation conducts the same businesses as previously operated by the constituent corporations, carry-overs and carry-backs of net operating losses and unused excess profits credits across the line of the fusion are allowable on the same basis as if the group of constituent corporations which, before the merger or consolidation filed consolidated returns, represents, collectively, after the merger or consolidation the same taxable enterprise as before that event.

Notwithstanding the foregoing, it is also held that under the 1939 Code, carry-overs and carry-backs of net operating losses and unused excess profits credits across the line of corporate fusions and successions effected other than by statutory merger or consolidation are not allowable. See

New Colonial Ice Company, Inc. v. *Helvering*, 292 U.S. 435, Ct. D. 841, XIII-1, 194, at 197 (1934), wherein, noting that the corporate merger there involved was not affected by operation of law, the Court held that a net operating loss carry-over was not allowable to the successor corporation and that this was so notwithstanding the fact that all the assets and the business of the older corporation were taken over by a new corporation, specially organized for the purpose and having substantially the same capital structure, in exchange for a portion of the stock of the new corporation which was distributed by the older corporation to the latter's stockholders share for share, thereby retiring the old shares.

Further, the taxpayer has the burden of establishing the correctness of the amount claimed as a net operating loss deduction or unused excess profits credit. Even after a statutory merger or consolidation subject to the 1939 Code, if the records of the resultant corporation are not maintained in such manner as to enable the Internal Revenue Service to make a reasonably conclusive determination as to the part of such deduction or credit allocable to the portion of the business of the resultant corporation conducted with the assets of the merged constituent, the claim will be regarded as having failed for lack of proof and will be disallowed.

The conclusions hereinbefore reached are directed generally to the effect of the *Libson Shops* decision on carryovers and carrybacks of net operating losses and unused excess profits credits across the line of statutory mergers or consolidations effected pursuant to the provisions of the 1939 Code. However, even though the merger or consolidation itself has been consummated prior to the effective date of the Internal Revenue Code of 1954, carryover and carrybacks across the line of such effective date are not to be regarded as permissible where their allowance would be in contravention of sections 172, 381, 382, 269, or other

provisions of the 1954 Code. Further, the principle announced in the *Libson Shops* case, under the 1939 Code, to the effect that a surviving corporation in a merger may not carry over and deduct pre-merger net operating losses of one business against post-merger income of another business operated and taxed separately before the merger, will not be relied upon by the Service as to a merger or any other transaction described in section 381(a) of the 1954 Code. But see sections 382(b) and 269 of the 1954 Code for the possible disallowance of net operating loss carryovers in such transactions, and see the regulations under section 368 of the 1954 Code for the requirements of a reorganization. See also Revenue Ruling 58-603, C.B. 1958-2, 147.

C. Text of Revenue Ruling 63-40, 1963-12 Int. Rev. Bull. 8.

Advice has been requested whether either the rationale of the decision in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382 (1957), Ct. D. 1809, C.B. 1957-2, 891, or the provisions of section 269 of the Internal Revenue Code of 1954 prevent the use of a net operating loss carryover under the circumstances described below.

1. The *M* corporation was organized in 1947 by three individuals who owned an equal number of shares of its authorized and outstanding stock. From the date of its incorporation until the early part of 1958 it was engaged in the fabrication and sale, through distributors, of household light steel products. The business was successful during its early years of operation. However, commencing in 1953 it sustained losses in each of its taxable years and over the period ending December 31, 1957, had accumulated substantial net operating losses.

In 1958 *M* corporation purchased for cash, at fair market value, all of the assets of *N* corporation, which had a history of successful operation of drive-in restaurants. *M* and *N* were unrelated corporations and none of the

shareholders of *M* corporation owned, directly or indirectly, any stock of *N* corporation. The funds for the cash purchase were derived in part from *M* corporation's own business assets and in part from an equal contribution to its capital of cash by its three stockholders. Shortly thereafter, *M* corporation discontinued its former business activity, sold the assets connected therewith, and engaged exclusively in the business of operating the chain of drive-in restaurants formerly operated by the *N* corporation.

Under the facts presented, neither section 269 nor section 382 of the Code is applicable and the sole question raised is whether the rationale of the *Libson Shops* decision bars the allowance of the net operating loss deduction attributable to losses incurred prior to the acquisition of the new business activity for *M* corporation's taxable year ended December 31, 1958.

In cases like the one discussed above, arising under section 122 of the Internal Revenue Code of 1939 or section 172 of the 1954 Code in which losses have been incurred by a single corporation and there has been little or no change in the stock ownership of the corporation during or after the period in which the losses were incurred, the Internal Revenue Service will not rely on the rationale of the *Libson Shops* decision to bar the corporation from using losses previously incurred by it solely because such losses are attributable to a discontinued corporate activity. Accordingly, since there was no change in stock ownership in *M* corporation either before the discontinuance of its former business activity or after the commencement of its new business activity, a net operating loss deduction is allowable for its taxable year ended December 31, 1958.

However, if there is more than a minor change in stock ownership of a loss corporation which acquires a new business enterprise, the Service may continue to contest the deductibility of the carryover of the corporation's prior losses against income of the new business enterprise. See,

for example, as involving substantial changes in stock ownership. *Milk Ridge Coal Co.* v. *Patterson*, 264 Fed. (2d) 713 (1959), certiorari denied, 361 U.S. 816 (1959); *A. C. Willingham* v. *United States*, 289 Fed. (2d) 283 (1961), certiorari denied, 368 U.S. 828 (1961); *Commissioner* v. *Virginia Metal Products, Inc.*, 290 Fed. (2d) 675 (1961), certiorari denied, 368 U.S. 889 (1961); *J. G. Dudley Co., Inc.* v. *Commissioner*, 298 Fed (2d) 750 (1962); and *Hugler's* v. *Commissioner*, 38 T.C. 773 (1962). Compare *Kolker Bros., Inc.* v. *Commissioner*, 35 T.C. 299 (1960), nonacquiescence at page 6 of this Bulletin, where part of the funds used by the corporation to purchase assets of a new business activity were borrowed from some non-stockholders who several months after the purchase acquired about 46 percent of the corporation's stock in exchange for the indebtedness owed them.

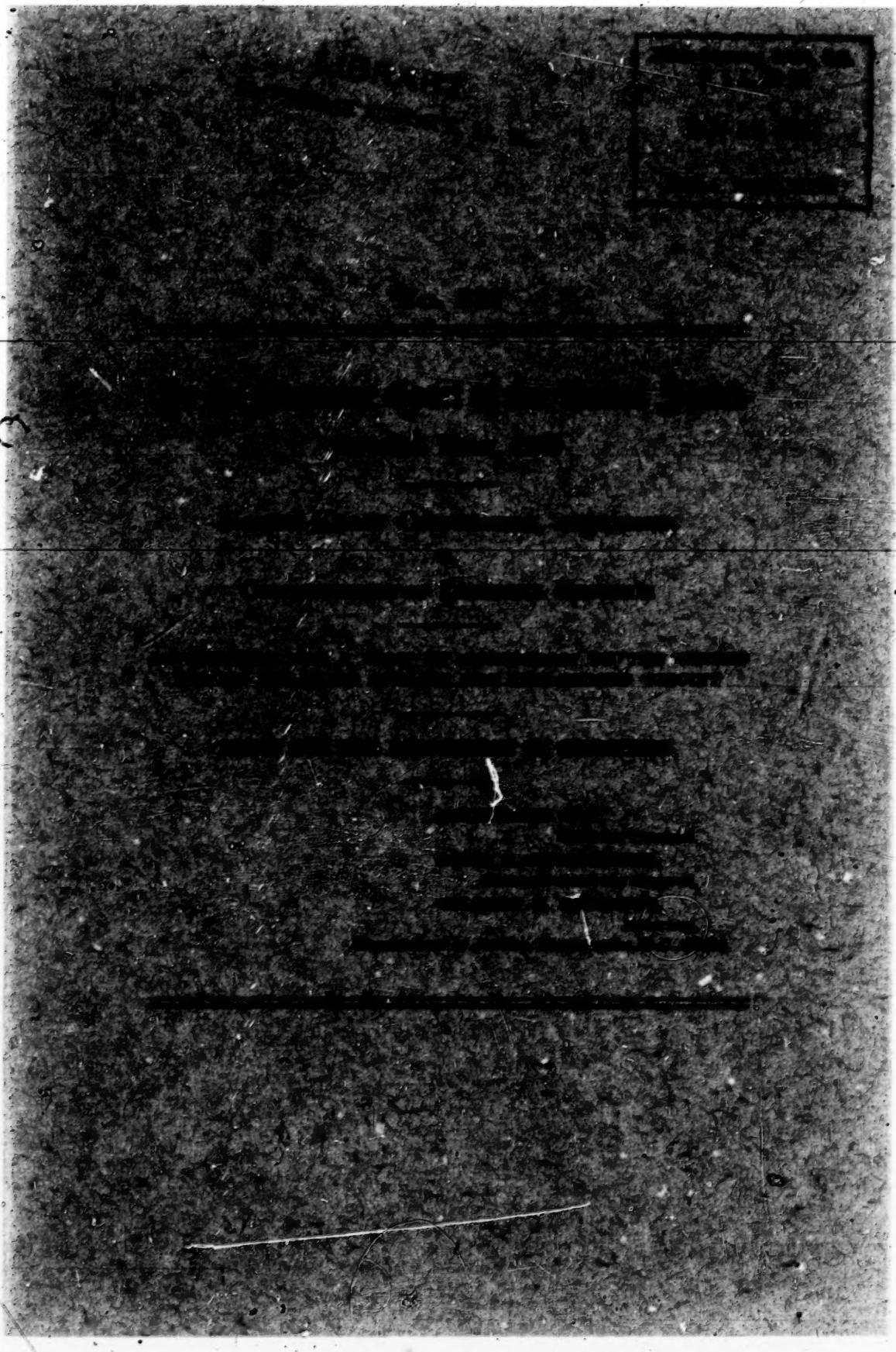
For a discussion of the Service position with respect to the application of *Libson Shops* to a merger or other transaction described in section 381(a) of the Code, see Revenue Ruling 58-603, C.B. 1958-2, 147. Further Service views concerning the application of *Libson Shops* are set out in Revenue Ruling 59-395, C.B. 1959-2, 475.

2. Advice has also been requested whether the Service would apply different treatment to a case involving the same facts as are set out in the foregoing except for a difference in the method of acquisition by *M* corporation of the assets of *N* corporation. In this second case *M* corporation first attempted in extended negotiations to purchase the assets of *N* corporation but the shareholders of *N* corporation were unwilling to consummate the transaction except by way of the sale of their stock to *M* corporation. *M* corporation purchased the stock of *N* corporation for cash, at fair market value, solely for the purpose of acquiring its assets to earn a profit with those assets and *immediately* liquidated that corporation under such circumstances that the basis of the assets to *M* corporation

will be determined by the amount it paid for the stock of *N* corporation.

Under the facts of this second case, the Service will not contend that the acquisition of control of *N* corporation has as its principal purpose the evasion or avoidance of Federal income tax for purposes of section 269(a) of the Code. Accordingly, section 269 of the Code will not, under these facts, bar the *M* corporation from carrying over its prior losses and the conclusion reached with respect to the first case is equally applicable here.

No opinion is expressed as to other cases where the facts show that the purchase price is payable over a substantial period of time (whether or not specifically payable only out of earnings of the business) or exceeds fair market value or where other circumstances may justify the application of section 269 of the Code.



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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 537

NORDEN-KETAY CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (Pet. 11a–23a) is not officially reported. The opinion of the court of appeals (Pet. 1a–8a) is reported at 319 F.2d 902.

JURISDICTION

The judgment of the court of appeals was entered on June 28, 1963 (Pet. 9a). A timely petition for rehearing was denied on July 30, 1963 (Pet. 10a). The petition for a writ of certiorari was filed on October 10, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below correctly disallowed the taxpayer's 1954 deduction of a net operating loss carried over from 1951 on the ground that there was not the necessary "continuity of business enterprise" between the enterprise suffering the loss and the enterprise seeking the benefit of the deduction.

STATUTES INVOLVED

Section 172(a) and (g) of the Internal Revenue Code of 1954 and §§ 23(s) and 122 of the Internal Revenue Code of 1939 are set out in part in the Appendix, pp. 16–17, *infra*.

STATEMENT

Prior to 1951, petitioner was engaged in the business of mining and selling bituminous coal under the name of Consolidated Coal Corporation. During the fall of 1950, an agent representing petitioner's largest shareholder interested the New York banking firm of Lehman Brothers in buying the stock of petitioner. Lehman Brothers acquired options to purchase a controlling share of the stock and then undertook to find a purchaser for the stock at a price that would yield it a $200,000 profit. It ultimately entered into an agreement for the sale of the enterprise to the Zeigler Coal & Coke Company at approximately the desired price, but at Zeigler's request the agreement was for the sale of petitioner's assets rather than its stock. Having found a purchaser, Lehman Brothers exercised its options and became the owner of 95% of petitioner's stock (47,447 shares). Two days later,

on February 28, 1951, petitioner transferred to Zeigler all its assets except cash and securities in exchange for an assumption of all of petitioner's liabilities and the payment of an amount of cash which, together with the retained cash and securities, gave petitioner liquid assets in the amount of $3,900,000. In addition, Zeigler promised to give petitioner a share of the proceeds from certain of the properties for which it had no need and which it proposed to resell (the "disposable properties") (Pet. 13a–15a). In order to cut off any contingent claims against the corporation (liability for which Zeigler had assumed), petitioner was required by the agreement to dissolve itself promptly after receipt of the final payment (see Pet. 9).

Upon consummation of the sale, petitioner filed a notice of intention to dissolve and immediately distributed, as a partial liquidating dividend, the $3,900,000 generated from the sale of the assets.[1] Its share of the distribution was used by Lehman Brothers to satisfy the bank loans and commissions incurred in purchasing the stock. About a year later, on March 26, 1952, petitioner accepted $250,000 in full satisfaction of its rights to share in the proceeds of Zeigler's sale of the "disposable properties" and promised, in accordance with the original agreement, to complete dissolution as quickly as possible (Pet. 15a, 17a).

[1] $3,824,541 was distributed immediately and the balance a little over two months later, in May 1951 (Pet. 15a; see Pet. 10).

At about the time of the final payment (March 1952), Lehman Brothers learned for the first time that the basis for petitioner's assets had been much in excess of the sale price and that their sale had accordingly given rise to a net operating loss for petitioner's 1951 taxable year in the amount of $3,466,387. Of that amount, $207,839 was absorbed by carryback to prior taxable years, but Lehman Brothers was advised that the remaining $3,258,548 of the loss might be eligible for carryforward to future years (Pet. 11–12, 18, 16a). In order to realize the benefit from its newly-discovered tax asset, petitioner undertook negotiations, ultimately successful, to be released by Zeigler from its commitment to dissolve,[2] abandoned its dissolution proceedings, and began searching for a profitable going concern to acquire (Pet. 15, 18a).

On April 6, 1953, petitioner entered into an agreement with the stockholders of a group of three closely-held companies engaged in the manufacture and sale of precision electronic components (the "Ketay" companies). Pursuant to the agreement, petitioner acquired all the stock of the Ketay companies, dissolved them, received their assets, elected the former Ketay stockholders as directors and officers, and, with an appropriate change of name (to Ketay Manufacturing Company) commenced operations as an electronic components manufacturer. In exchange for the Ketay stock, petitioner gave the

[2] To obtain the release, petitioner was required to reassume liability for any claims that would have been cut off by a timely dissolution (Pet. 15).

Ketay stockholders: $100,000 in cash; notes for $2,650,000 payable in installments over a five-year period; and warrants to purchase 25,000 newly-authorized shares of its common stock for $125,000.[3] The warrants were exercised in due course and gave the old Ketay stockholders approximately 34% of the outstanding stock of petitioner (Pet. 18a–21a).

Petitioner's net income from the electronics business was $1,108,410 for 1953 and $1,226,880 for 1954 (Stip. ¶ 44). For both years it claimed net operating loss carryovers from 1951 which completely eliminated its taxable income. For 1954, the year involved in this proceeding, the Commissioner disallowed the carryover deduction and determined a deficiency, as a consequence, in the amount of $630,033. The Tax Court upheld the deficiency (Pet. 11a–23a), and the court of appeals affirmed (Pet. 1a–8a).

ARGUMENT

Prior to February 1951, petitioner was engaged in the mining and sale of bituminous coal. In that month, Lehman Brothers acquired 95% of its stock in

[3] The exercise price of $5.00 per share, as petitioner notes (Pet. 16, n. 5), was "approximately equal to the underlying net assets value of petitioner's shares at the time," *i.e.*, the $250,000 in cash received from Zeigler divided by 50,000 authorized shares." It did not, however, reflect either the value of petitioner's major existing asset—a net operating loss of $3,258,548 which, if allowed as a carryforward, would produce (at a 52% tax rate) a tax saving of $1,694,445—or the value of the newly-acquired assets. Thus, contrary to petitioner's implication, the warrants to purchase the stock were exercisable at a relatively nominal price and were an important part of the consideration given by petitioner for the assets acquired.

order to effectuate a pre-arranged sale of all of its assets. Upon consummation of the sale, all of the proceeds except for the final payment of $250,000 were distributed in liquidation and dissolution of the corporation was initiated. For the following two years, petitioner was a defunct corporation. It had no operating assets, no business, and no prospects. It did, however, have a net operating loss of over $3 million which, if it could be carried over against the income of some other business, would yield a tax saving of over $1.5 million. In April 1953, the petitioner's corporate shell was utilized to absorb an existing electronics business previously operated by three corporations wholly unrelated to petitioner. After petitioner's absorption of the Ketay enterprises, Lehman Brothers owned 58.5% of the common stock[1] and the Ketay stockholders owned 34%, plus corporate notes in the amount of $2,650,000. The $250,000 cash that petitioner brought to the amalgamation was minor in relation to the total value of the enterprise, and the major consideration for the substantial

[1] In March 1951, following Lehman Brothers' recovery of all but $1.50 per share of its original investment, it sold 7116 of its 47,447 shares for $1.50 a share to persons (Becker and Weir) who were entitled to participate with it in any profit from the venture (Pet. 16a). Since those persons had participating rights in the venture from the outset, however, we will treat them as co-participants of Lehman Brothers and ignore that transfer of ownership. In April 1951, Lehman Brothers sold 3500 shares to a third party (McConnell), reducing its holding to 43,947 shares (Pet. 16a). That reduced holding was about 88% of the shares originally outstanding (50,000) and about 58.5% of the shares outstanding (75,000) after the issuance of 25,000 new shares to the Ketay stockholders.

interests Lehman Brothers acquired in the electronics enterprise was the $3 million net operating loss available to petitioner. Conversely, what the Ketay stockholders got in exchange for the substantial interests in the electronics business they gave up in the amalgamation was primarily the prospect that, by virtue of petitioner's loss carryovers, the next $3 million of income produced by the business would be tax-free. In substance, the transaction was but a "merger," in a non-technical sense, of petitioner's net operating loss with the Ketay enterprises' profitable electronics business, to the benefit, hopefully, of the former stockholders of both. The courts below held that the Code did not contemplate such a use of a net operating loss carryover, and accordingly disallowed the claimed deduction of the losses of the former coal business against the post-amalgamation income of the electronics business. That decision, we submit, is correct and there is no conflict of decisions or other reason for review by this Court.

1. Although involving a different factual situation, this case is controlled by the rationale of this Court's decision in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382. The loss carry-over provisions of the Internal Revenue Code of 1939 were there interpreted to require a "continuity of business enterprise" between the corporation sustaining the losses and the corporation seeking to offset those losses against income in later years. The Court recognized that "Congress primarily was concerned with the fluctuating income

of a single business" (353 U.S. at 387), and that the carry-over provision was "designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year" (353 U.S. at 386). Consequently, the Court held that a corporation formed by the merger of 17 commonly-owned corporate entities could not, because of want of "continuity," deduct losses carried over from three of the merged corporations.

The result reached by the court of appeals in the present case follows *a fortiori* from the holding of *Libson Shops*. In *Libson Shops*, the only lack of continuity (since the same stockholders owned the corporations both before and after the merger and the several businesses, although Consolidated, remained unchanged) was that the pre-merger losses of three of the stores were being used to offset the post-merger income of the *other* stores. Here, however, petitioner seeks to carry over losses sustained while engaged in one business enterprise under the ownership of one set of stockholders against income realized in an entirely different business venture under significantly different ownership. Apart from the fact that the two businesses were conducted under the same corporate charter—a formalistic test eschewed by this Court in *Libson Shops*—the only connection between the two enterprises is that Lehman Brothers, having acquired an interest in one solely to consummate a pre-arranged sale of its assets, then traded the tax advantages promised by the resulting losses for a participating interest in the profits of the other. That relationship is plainly inadequate to bring this

case within the reach of the congressional concern on which the carryover provisions are based. As the court of appeals said (Pet. 5a–6a):

> No intelligible legislative purpose would be served by permitting a substantially new group of shareholders engaged in a different enterprise to benefit from the losses sustained by earlier owners in another business. In such a case, the corporate entity is the only link between them. The basic teaching of *Libson Shops* is that this is not enough. * * *

2. Petitioner contends (Pet. 23–30) that this Court's decision in *Libson Shops* stands only for the narrow proposition that a merger between corporations *A* and *B* does not entitle the merged corporation to offset *A*'s earnings with *B*'s pre-merger operating loss if *B* was not so affiliated with *A* before the merger that the two could then file a consolidated return and thereby net their profits and losses. This restrictive reading of *Libson Shops* is contrary to the understanding of that opinion applied in a consistent line of decisions in courts of appeals. See *J. G. Dudley Co.* v. *Commissioner*, 298 F. 2d 750 (C.A. 4); *Commissioner* v. *Virginia Metal Products, Inc.*, 290 F. 2d 675 (C.A. 3), certiorari denied, 368 U.S. 889; *Mill Ridge Coal Co.* v. *Patterson*, 264 F. 2d 713 (C.A. 5), certiorari denied, 361 U.S. 816; *cf. Willingham* v. *United States*, 289 F. 2d 283 (C.A. 5), certiorari denied, 368 U.S. 828; *Patten Fine Papers* v. *Commissioner*, 249 F. 2d 776 (C.A. 7).

Moreover, petitioner's proposed reading is not supported by this Court's stated rationale in the *Libson Shops* opinion, which placed emphasis not on what

the merged corporations could or could not do prior to the merger[8] but on the continuity of the business venture. The Court limited the availability of the carry-over provision to cases in which "there is a continuity of business enterprise," a standard which was further explained as limited to the situation in which "income is derived from the *operation* of substantially the same *business* which produced the loss." 353 U.S. at 386. (Emphasis added.)

Finally, as the court of appeals suggested (Pet. 7a), the carryover in this case would not be allowable even if *Libson Shops* were limited, as petitioner would limit it, to cases involving a "merger" of previously unrelated corporations and an attempt thereby to "pool" profits and losses that "had arisen in separate pools" (Pet. 26–27). For the fact is that this case does involve, in every but the most technical sense, just such a "merger" of previously-unrelated corporations. At the corporation level, the transaction resulted, just as would a merger, in the putting together in one corporate entity of the assets of several formerly-separate corporations: the Ketay corporations contributed the operating assets of their going electronics business, and Consolidated contributed its remaining $250,000 of undistributed cash and a potential loss carryover of $3 million. At the

[8] Indeed, it was assumed in *Libson Shops* that the merging corporations *could* previously have filed consolidated returns and had merely "chosen" not to (see 353 U.S. at 388). While the assumption was erroneous, petitioner's explanation would thus make the decision inapplicable to the very circumstances assumed by the Court in deciding the case.

stockholder level, the transaction resulted, again just as would a merger, in the stockholders of the several "merging" corporations all becoming stockholders of the single surviving corporation, thus keeping their investment in the enterprise "in solution": the Consolidated stockholders remained as stockholders of the surviving corporation, and the Ketay stockholders received 34% of the stock of the surviving corporation as a major part of the consideration for the contribution of the Ketay properties (see note 3 *supra*). The Ketay stockholders also, it is true, received notes, but the notes were dependent for their payment upon the continued financial success of the contributed electronics business and thus similarly represented a continuing interest in that enterprise.[6] Thus, far from being a mere "purchase" of assets by a single corporate entity, this case involves, just as did *Libson Shops*, a "pooling" of the assets of several previously unrelated corporations with their stockholders retaining their investment in the enterprises as stockholders of the "pooled" enterprise. In petitioner's own words, if a "post-merger deduction of pre-merger losses" were allowed in such circumstances, "the stockholders would thereby retroactively have achieved a netting of profits and losses which was not allowable under the organizational form originally

[6] The extent of the Ketay stockholders' continuing "participation" in the surviving corporation is reflected also in their becoming its officers and continuing to manage the business.

selected. A merger alone should not retroactively create such a tax advantage" (Pet. 28–29).[7]

3. The decision below is not in conflict with *Hawaiian Trust Co.* v. *United States*, 291 F. 2d 761 (C.A. 9). In that case, the "Refiners" corporation, in 1950, acquired sufficient stock (over 95%) of the "Hilo Gas" corporation to qualify it as an "affiliate" for purposes of filing consolidated returns. After the stock acquisition, Hilo Gas sold its operating assets, partly to Refiners but mostly to another corporation (Honolulu Gas) also owned by Refiners' stockholders. Hilo Gas continued in existence, but its activities thereafter were confined primarily to subletting office space, in buildings it leased, to Refiners and Honolulu Gas. The sale of its assets, which produced a substantial loss, was reported on a consolidated return for

[7] The only distinction of this case that petitioner's argument would permit is that the "merger" in *Libson Shops* was a tax-free "reorganization" so that no gain or loss was recognized on the exchanges incident to it. In this case, petitioner's acquisition of the Ketay stock (or assets) did not qualify as a "reorganization" because it was not "solely * * * for * * * voting stock" but for stock warrants and notes (§ 112(g)(1)(B) and (C), 1939 Code), and the Ketay stockholders were accordingly taxable on the gain, if any, realized by them in exchanging their Ketay stock for petitioner's stock warrants and notes. Petitioner has yet to explain, however, why there is *more* reason to allow a loss carryover across a taxable merger than across a nontaxable one. Any such distinction would mean that, in the *Libson Shops* context, a loss carryover could be assured by the simple expedient of arranging the merger so as not to qualify as a "reorganization" (and, if necessary under petitioner's analysis, choosing the "loss" corporation to be the surviving legal entity).

1950 filed by Refiners and Hilo Gas. The loss was later sought to be carried over to a consolidated return for the same group filed for 1953. Rejecting on the facts a claim that the Hilo Gas stock had been acquired for the purpose of "evasion or avoidance" of income tax so as to bar the deduction under § 129 of the 1939 Code, the court allowed the loss carryover.

Although the differences between the cases are many, the most obvious is that in *Hawaiian Trust* the enterprise whose profits were sought to be reduced by the carryover (by means of a consolidated return) was already affiliated with the enterprise incurring the loss at the time the loss was incurred. The real question there was whether Refiners was entitled to file a consolidated return with Hilo Gas in 1950, the year the loss arose, for, if it was, there could be no greater objection to the loss being carried forward to subsequent consolidated returns for the same corporate group. This case would be analogous to *Hawaiian Trust* (though differences would still remain) only if petitioner's stock had initially been acquired, not by Lehman Brothers but by the Ketay corporations themselves,[*] and petitioner and the Ketay corporations had then filed a consolidated return for 1951 reporting the post-affiliation loss. Because of the factual differences, moreover, the only issues discussed by the court in *Hawaiian Trust* concerned the application of § 129 of the 1939 Code (tax-avoidance

[*] To establish the necessary relationship for consolidation, the three Ketay corporations might have had first to merge themselves into a single corporation which, upon acquiring petitioner's stock, would become its parent.

acquisitions) and eligibility to file consolidated returns under § 141; *Libson Shops* was not even cited.

4. The *Libson Shops* case involved a taxable year fully governed by §§ 23(s) and 122 of the 1939 Code. Although this case involves transactions (including petitioner's acquisition of the Ketay properties) occurring during 1939 Code years, the carryover being claimed is to a year (1954) governed initially by § 172 of the 1954 Code.* Despite their somewhat different form, however, petitioner does not claim that there is any important difference between § 172 itself—the basic carryover provision of the 1954 Code—and the predecessor provisions of the 1939 Code that were construed by this Court in *Libson Shops*.

In addition to the basic carryover provision (§ 172), the 1954 Code contains two new provisions expressly prescribing the extent to which net operating losses may be carried over across tax-free "reorganizations" (§ 381) and expressly denying a corporation the right to carry over losses following certain changes of ownership (essentially, a 50% change) and a simultaneous change of business (§ 382). Those provisions,

*Section 172(g)(4) provides in turn, however, that "the determination of the taxable years * * * to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939." Whether the 1939 Code is controlling for any purpose other than determining the number of years over which a loss may be carried forward is immaterial here, since, as noted in the text, there is no difference material to the question here between § 122 of the 1939 Code and § 172 of the 1954 Code.

however, are applicable only in the case of transactions occurring after June 22, 1954, the date of the 1954 Code (see § 394 (a) and (b)), and thus have no application to this case. Petitioner's arguments based upon those provisions (Pet. 31–39) are accordingly irrelevant. Far from being a reason for review of this case, a consideration of the effect of those provisions must await a case involving transactions occurring after their effective date.

CONCLUSION

For the foregoing reasons, the petition for certiorari should be denied.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939 (as amended, 26 U.S.C., 1952 ed.):

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(s) *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

* * * * * * *

SEC. 122. NET OPERATING LOSS DEDUCTION.

(a) *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) *Amount of Carry-Back and Carry-Over.*—

* * * * * * *

(2) *Net operating loss carry-over.*—

* * * * * * *

(B) *Loss for taxable year beginning after 1949.*—If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the five succeeding taxable years. * * *

* * * * * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

> SEC. 172. NET OPERATING LOSS DEDUCTION.
>
> (a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.
>
> * * * * * *
>
> (g) *Special Transitional Rules—*
>
> (1) *Losses for taxable years ending before January 1, 1954.*—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.
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